



# The OECD Global Anti-Base Erosion Proposal

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# The OECD Global Anti-Base Erosion (“GloBE”) proposal

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## Executive Summary

The OECD’s Global Anti-Base Erosion (GloBE) proposal was formally introduced in January 2019 and the most recent consultation document was published in November 2019. Despite being introduced as part of the debate about reforming taxes in the context of the digitalisation of the economy, the GloBE proposal is more general.

The GloBE proposal has two main elements. The first is an *“income inclusion rule* that would tax the income of a foreign branch or a controlled entity if that income was subject to a low effective tax rate in the jurisdiction of establishment or residence”. The second is a *tax on base eroding payments* which “would deny a deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate.” A number of design options are being considered for each of these elements of the proposal.

### ***Policy Analysis***

The proposal appears to have two main objectives: first, to extend the BEPS project to further combat profit shifting and, second, to reduce tax competition. These are supplemented by a desire to prevent the proliferation of uncoordinated anti-avoidance measures. It has also been suggested that the GloBE is pro-growth on the grounds that it would induce a better allocation of capital across countries.

The pursuit of the second objective (targeting tax competition) requires a much more ambitious design than that required by the first objective (targeting profit shifting). It would also require a departure from the policy consensus agreed only a few years ago during the BEPS project; according to the approach of the BEPS project, “no or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.” Addressing tax competition through the GloBE proposal would mean that “no or low taxation” is now considered to be

*per se* a cause of concern. If this approach were adopted, countries would in effect not be allowed to tax the profits generated through real activity taking place within their border at any rate of their choosing.

However, some of the design options being discussed effectively narrow the GloBE proposal to a measure that targets profit shifting but not tax competition. Whether there will be this fundamental shift in policy is therefore still unresolved.

The income inclusion rule introduces taxation in the location of the parent on accrued profit arising in other countries. The proposal could therefore be interpreted as a move in the direction of taxing profit in the location of the parent (a different direction to that proposed under the OECD's Pillar I proposal). The rationale for this direction of reform has not been adequately justified. There is an important issue of principle in taxing in the location of the parent, in that the link between the parent and the profit of the multinational is weaker than with the ultimate shareholders, activities and sales of the business. It could be argued that the ultimate goal of the GloBE proposal is not to tax profit in the location of the parent, but to put a floor on competition in "source" countries. But that in turn raises issues of sovereignty.

There are also issues of practice. It appears likely that the GloBE proposal will not achieve its two primary objectives unless (i) it is adopted by all or most countries; (ii) countries agree to a detailed set of harmonised rules; and (iii) the harmonised rules incorporate a strong form of minimum tax. Even then, it is not clear that some technical issues, such as those involved in the calculation of effective tax rates, can be solved. We briefly address these issues in turn.

#### (i) Adoption by all or most countries

Achieving the aims of the GloBE proposal in practice is likely to require all – or certainly most – countries to implement it. If one country did not implement it, then multinationals would have an incentive to move their parent company to that country. Preventing this with anti-inversion rules and exit taxes could prove difficult. In any event, these rules cannot prevent new businesses being set up in that country.

Countries that implemented the GloBE proposal would in effect be raising their taxes. Doing so would go against the trend for countries to reduce tax rates to compete with each other for real activity and profit. It is therefore not clear why countries would agree to implement it. And even if they did, they would have an incentive to subsequently abandon it. However, it should also be noted that countries – partly in response to the BEPS proposals - have implemented many forms of anti-avoidance rules at the same time as competing on other aspects of their tax systems.

Countries thus have an incentive to resist joining a group of countries adopting the GloBE proposal. It has been suggested that the second element of the proposal – the *tax on base eroding payments* – addresses this concern by acting as a stick to compel countries to adopt the GloBE. But it is not at all clear that this element of the proposal can be designed to be an effective stick.

## (ii) Harmonisation of details

Even if the GloBE proposal were introduced universally, then there would need to be considerable harmonisation of the details. For example, the threshold rate would need to be harmonised, as would the tax base. The latest consultation envisages using financial accounts, which would create a number of problems. Failure to harmonise these details would impinge on the GloBE proposal's ability to achieve its stated objectives.

## (iii) Strong form of minimum tax

Universal agreement with full harmonisation of detailed rules would still not be sufficient to achieve the stated objectives. To achieve both objectives countries would have to agree to follow a strong form of the rules. At the time of writing a carve-out based on substance is mentioned as an option in the consultation documents. Such a carve-out would scupper the proposal's ability to address tax competition. The consultation documents also leave open whether the GloBE proposal would be implemented on an entity-by-entity, country-by-country basis, or whether it would apply in a "blended" form to the aggregate foreign activities of a multinational. These approaches have different effects. Blending would lead to a proposal that only weakly targets tax competition.

Even if a strong form of the GloBE proposal were agreed universally, questions remain as to whether some mechanisms that are at the heart of the proposal – most prominently the calculation of the effective tax rate – could work from a technical perspective.

In conclusion on the policy analysis, alternatives for radical business tax reform, such as the Destination Based Cash Flow Tax, offer greater promise in addressing both profit shifting and tax competition.

## ***The Effect on Revenues***

We combine a number of different datasets to estimate the impact on tax revenues of the introduction of the income inclusion rule, assuming that the proposal is adopted universally. The results are subject to considerable uncertainty due to the lack of reliable data. We do not take into account any behavioural response to the introduction of the GloBE; this would add even more uncertainty to the estimates. It also does not take into account taxes already levied at the parent level, such as those based on CFC rules and the US GILTI provision.

Our preferred approach to analyse the country-by-country approach is to use financial accounting data on foreign-controlled subsidiaries across a large number of countries. For each entity it is possible to estimate its existing effective tax rate and the additional tax that would be due under the GloBE proposal, at different levels of the threshold. This accounts for heterogeneity across firms. Where that is not possible, we use aggregate data for a country as a whole.

Following this approach, our central estimate is that the country-by-country approach with a threshold effective tax rate of 10% would yield additional revenue worldwide of around \$32 billion, or around 14% of the taxes currently paid by foreign-controlled entities. This represents less than 2% of total taxes currently levied worldwide on corporate profit, and approximately one third of 1 percent of total worldwide corporate profit. The highest revenues would be sourced from the British Virgin Islands, Puerto Rico, Ireland, Bermuda, Cayman Islands, Luxembourg, Netherlands and Singapore.

More speculatively, if these revenues were collected by the country of the ultimate parent company, then the largest beneficiaries in absolute terms would be the world's largest economies, such as China and the United States. Relative to their own tax revenues, several Eastern EU member states would also gain substantially. However, if the GloBE were introduced on a country-by-country basis, there would be likely to be a significant impact on tax rates in low tax countries; in this case, they would become the main recipients of the additional revenue generated.

To examine the blended approach, applicable to the entire foreign operations of a multinational, we examine the consolidated accounting figures for foreign earnings and foreign taxes. We find that, also with a threshold effective tax rate of 10%, the GloBE would raise tax revenues of around 4% of the taxes paid by foreign-controlled entities.

However, these two approaches create different incentives for both multinationals and governments, as set out below.

### ***The Effect on Incentives***

The report examines the impact of the proposal for the income inclusion rule on three types of behaviour of multinational companies:

- The location of real economic activity
- The scale of real economic activity, conditional on location, and
- The extent of profit shifting.

There is considerable economic evidence that taxes affect the location of real economic activity. The converging of effective tax rates would lessen the tax advantages to choosing a low tax country, and it has been claimed that the GloBE proposal would achieve that. On the other hand, implementing the GloBE proposal would raise the cost of capital, thereby diminishing overall investment.

A simulation model is used to identify the effects of the GloBE proposal, under two forms of implementation – a country-by-country threshold and a blended approach at the level of the multinational. The key results from the simulation model are that the country-by-country approach would generate:

- a much stronger effect in mitigating profit shifting, but

- a steeper rise in effective average tax rate (EATR), and
- a steeper rise in cost of capital.

The GloBE proposal does not have a strong effect in creating a convergence of EATRs.

The choice between a country-by-country approach and a blended approach therefore involves a trade-off. The country-by-country approach would combat profit shifting more effectively. But, largely as a result of this effect, it would also raise the cost of capital further and hence create more economic inefficiencies through lower investment.

This reflects a classic trade-off in considering taxes that create economic inefficiencies, as existing taxes on business profit clearly do. The only solution to this trade-off would be to adopt taxes that are less economically inefficient.

### ***The GloBE and EU Law***

EU law imposes a number of constraints on the GloBE proposal. The proposal should comply with existing directives, such as the Interest and Royalties Directive, or, more likely, the directives will have to be amended to accommodate the proposal. The difficulty here is political rather than technical as it requires unanimous agreement among Member States. The proposal should also comply with primary EU law including treaty provisions concerning Fiscal State Aid and the fundamental freedoms. The report focuses on the latter.

The safest route for compliance with the case law of the Court of Justice of the European Union on the fundamental freedoms is the inclusion of a substance-based carve-out. At least two alternative routes may be available if no such carve-out is adopted, although compatibility with EU law is less certain under both. The first is to extend the proposal to domestic subsidiaries. The second is to present the primary objective of the proposal to be that of achieving a broader policy objective such as the equality of treatment of domestic and foreign investment, rather than addressing avoidance. The likelihood that the second route would be found to be compatible with EU law is increased if the proposal is unanimously agreed by Member States and adopted through a directive. However, there is less certainty around these routes than there is on the inclusion of a substance-based carve-out.



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## **PART 1. Introduction and Policy Analysis**

### **1. Introduction**

The OECD’s “Global Anti-Base Erosion” (GloBE) proposal was formally introduced in January 2019 as part of a consultation on “Addressing the Tax Challenges of the Digitalisation of the Economy” (OECD, 2019a).<sup>1</sup> It is currently being considered by the members of the Inclusive Framework. While the proposal arose in the context of the debate about taxing digital businesses, it clearly has broader ambitions and, indeed, a broader scope – it targets the system for taxing business profit in an international tax setting as a whole.

There appears to be a tension at the heart of the proposal stemming from a divergence between the two primary objectives that have been set. The main objective appears to be that of curbing profit shifting. In this sense, GloBE can be seen as a continuation of the BEPS project. A second objective is to address tax competition. This goes considerably further than BEPS and aims to effectively limit the extent to which countries might reduce their tax rates

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<sup>1</sup> In a report of December 2018, the Secretary-General of the OECD noted that “France and Germany have now proposed to explore the feasibility of a global anti-base erosion mechanism”. OECD, 2018, p. 9.

to attract real investment and activity. Critically, whether the first objective, or both, are pursued should significantly affect the design of the proposal. At the time of writing, it appears that this tension has not yet been resolved. The extent to which this second rationale is pursued in the final proposal is thus still to be seen.

Profit shifting and tax competition undermine the existing system and give rise to questions about its long-term viability. The GloBE proposal - together with the OECD's Pillar 1 proposal – is the most recent, and most far-reaching, attempt to patch up the ailing existing system. This report focuses solely on the GloBE proposal, Pillar 2; it does not address the potential interactions of the two pillars together.

The main element of the proposal is an “*income inclusion rule* that would tax the income of a foreign branch or a controlled entity if that income was subject to a low effective tax rate in the jurisdiction of establishment or residence” (OECD, 2019b, p.25).

It gives the government of a parent company the right to tax that income – irrespective of whether that income might be considered to be generated in that country. The income inclusion rule is a form of minimum tax. Its intent is to prevent the overall effective tax rate of foreign branches and controlled entities falling below some minimum threshold. There is no presumption that the income subject to the new rule should have arisen – or value should have been created - in the country of the parent company.<sup>2</sup>

A second proposed provision is to tax income in the country from which payments are made. A *tax on base eroding payments* “would deny a deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate.” This is closer to provisions introduced by BEPS.<sup>3</sup> This provision does not appear to apply solely to payments made by parent companies to foreign branches or controlled entities, and so is quite distinct from the income inclusion rule.

Below, we consider the objectives of the GloBE proposal, and ask three questions:

- (i) whether the objectives are justified;
- (ii) whether the proposed reform achieves these objectives; and
- (iii) whether other possible reforms might achieve these objectives more successfully.

Before addressing these questions, we try to discern a principle which justifies either of the approaches just described.

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<sup>2</sup> Since the BEPS project, the underlying principle of the international tax system has typically been taken to be that profit should be taxed in the location in which value is created; see OECD (2013). However, this has been widely disputed both as a normative principle, and as a matter of practice; see, for example, Devereux and Vella (2018).

<sup>3</sup> See OECD (2015a).

## 2. What principle justifies the approach of the GloBE?

A starting point for thinking about the GloBE proposal is how it affects, or is intended to affect, the overall allocation of rights to tax multinational profit.

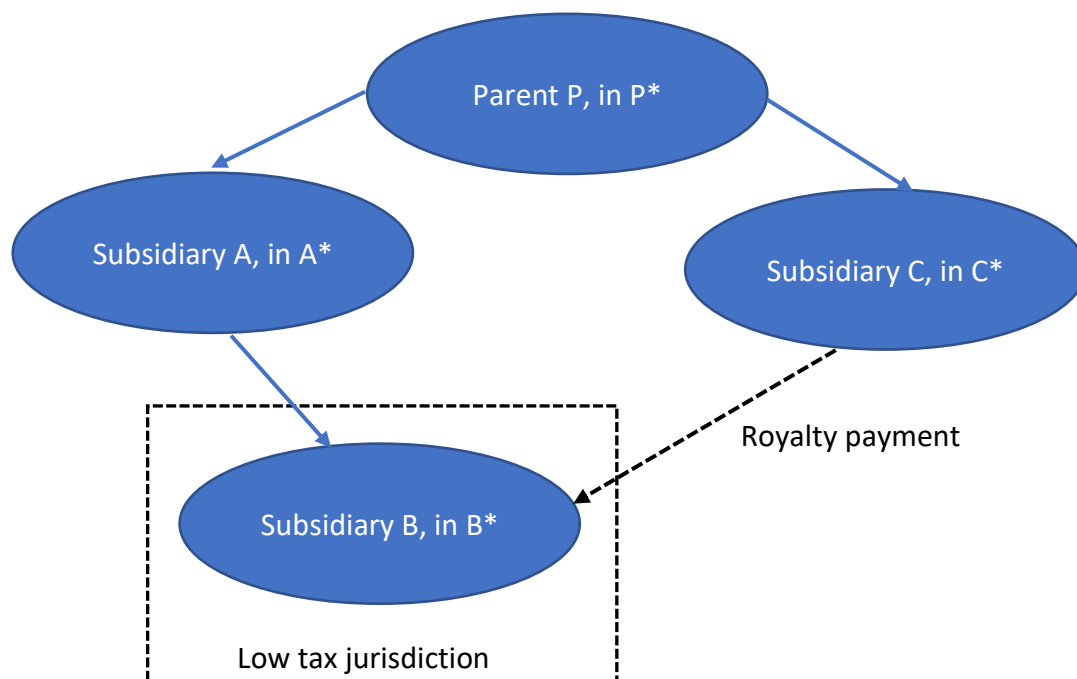
### *Value creation*

The guiding principle adopted in the BEPS project was that profit is, and should be, “taxed where economic activities generating the profits are performed and where value is created”.<sup>4</sup> Moreover, it was argued that “fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that *artificially segregate taxable income from the activities that generate it*. (...) A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments.”<sup>5</sup>

It is possible to take exception to the claim that profit is, and should be, taxed where value is created.<sup>6</sup> But despite its shaky foundation both in fact, and as a normative account of how profit should be taxed, the notion has been widely adopted - not just in the BEPS project, but by the European Commission and several national governments, including the UK. It therefore seems fair to ask whether the GloBE proposal is line with this approach.

The answer is clearly no. In Figure 1.1 we set out a very simple example structure that is instructive in illustrating different issues and to which we return to below.

**Figure 1.1 Example Structure**



<sup>4</sup> OECD (2014), p.4.

<sup>5</sup> OECD (2013), page.13 (emphasis added).

<sup>6</sup> See Devereux and Vella (2018) for an example of a critical view of this concept.

Suppose that a parent company, P, resident in country P\*, has a subsidiary, A, resident in country A\*. A has a subsidiary, B, resident in country B\*. Country B\* has a low tax rate. P also has a separate subsidiary, C, resident in C\*. Then suppose that C makes a royalty payment to B. Then, under the two elements of the proposal, there are three possible new locations in which the profit arising in B might be taxed: P\*, A\* and C\*. P\* or A\* might impose tax under the income inclusion rule and C\* might impose tax under the undertaxed payment rule.

But the justification for taxing in any of these countries is *not* based on the claim that value is created there. If the value of the intangible asset were generated in country D\*, for example, then the value creation approach should be that the profit is taxed in D\*. Neither of the two main elements of the GloBE proposal achieve that outcome. The potential conflicts within the GloBE proposal between taxing rights in different countries will need to be addressed by ordering rules, as suggested by the OECD; it is as yet unclear what these would be. In the empirical research reported below, we analyse the likely impact of the universal adoption of the income inclusion rule being levied at the level of the ultimate parent (P in our example); this implicitly assumes that the income inclusion rule takes priority over the tax on base eroding payments.

The 2013 BEPS Action Plan had stated that “no or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.” There has been a striking volte-face on this point. Countries promoting Pillar II now appear to believe that “no or low taxation” *is* a cause of concern, even if real economic activities take place in the countries imposing no or low tax.

There is mention in the OECD’s documentation that there could be a carve-out from the GloBE if there is sufficient “substance” in the entity with the low effective tax rate. As conceded in the November 2019 consultation document, if substance-based carve-outs were to be adopted – and thus keeping somewhat more in line with the value creation principle - they “would undermine the policy intent and effectiveness of the proposal”.<sup>7</sup> A GloBE proposal with a substance carve-out would be directed at profit shifting but not tax competition, as countries could continue to compete through the tax system over real activities. But if there is no substance requirement, then the GloBE proposal seems to fly in the face of the OECD BEPS logic.

#### *Justification for taxing in the location of parent*

The proposal introduced so far (including as set out in the most recent document in November 2019)<sup>8</sup> is not clear on precisely which parent (or parents) should have the right to exercise the income inclusion rule. In the example in Figure 1.1, either the ultimate parent in P\* or the immediate parent in A\* could tax the profit of the subsidiary B, resident in B\*. It is not clear which would have the right to exercise the new taxing right.

We here focus on the allocation of taxing rights to the ultimate parent company. It is not clear on what principled basis this would be done. Consider the example of the multinational

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<sup>7</sup> OECD (2019e), p.23.

<sup>8</sup> OECD (2019e).

company headquartered in P\*. Suppose it is ultimately owned by shareholders all over the world. Suppose its activities take place almost exclusively outside P\*. And suppose it makes no sales in P\*. Then the justification for giving taxing rights to P\* over the profit of the multinational seems weak. What is there in P\* which would justify the government of that country receiving the tax revenue? The countries where the ultimate shareholders, the activities and the customers are located would appear to have a stronger claim to tax the profit than P\*.

The concept of corporate residence is in any case notoriously problematic. While rules that adopt a substantive test (e.g. “central management and control”) are more robust than rules that adopt formal tests (e.g. incorporation), they are still susceptible to manipulation. This brings into question building significant reform around this concept.

It may be argued that the aim of the GloBE proposal is not to allocate taxing rights to the location of the parent company, as that is merely a means to an end. The proposal would instead be intended to provide incentives to low tax countries to increase their tax rates to the threshold rate, and companies, in turn, would have reduced incentives to shift profit and real activities from high to low tax countries. As explained below, it is not clear that the proposal can be designed in a way that achieves this aim. But if this were successful, then clearly political and economic pressure would have been brought to induce countries to change their tax rates, arguably undermining their sovereignty, and raising questions about what principles would be guiding the allocation of taxing rights under the resulting system.<sup>9</sup>

#### *The principles underlying Pillar I and Pillar II*

Of course, the GloBE proposal (Pillar 2) is being made at the same time as the OECD’s Pillar 1 proposal to allocate some taxing rights to the market country. There has been some attempt to claim that the Pillar 1 approach is consistent with the value creation approach, although that case is also weak. The proposals aim to move in different directions. Pillar 1 would allocate taxing rights to the market country and Pillar II would allocate taxing rights to the country of the parent. If a package including both Pillars 1 and 2 is adopted, the world will also continue to tax profit in all the locations in which it currently does so. In addition, it will also tax profit in the market country. And in addition to that, the GloBE proposal would also allocate taxing rights to the country of the parent, and the country from which a payment is made.<sup>10</sup> This approach may yield higher revenues; but it is likely to be at a considerable cost in terms of complexity and uncertainty.

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<sup>9</sup> On the existing system see Devereux and Vella (2014).

<sup>10</sup> This is more evidence of a “Marxist” approach to international taxation: see the blog at <http://business-taxation.sbsblogs.co.uk/2017/11/17/a-marxist-approach-to-international-taxation/>, which refers to the Groucho Marx quote: “those are my principles, and if you don’t like them, well I have others”.

### 3. The objectives of the GloBE proposal: are they justified?

Notwithstanding the lack of an obvious principle, we now turn to address the objectives set out by the OECD, and to ask whether the objectives are justified. The objectives are not very clearly set out in the OECD documents. However, we noted that the first two objectives are to:

- a) address profit shifting, and
- b) address tax competition.

The OECD documentation also mentions a third objective, to:

- c) Stop proliferation of uncoordinated anti-avoidance measures.

In addition, it is worth addressing a further objective put forward by Englisch and Becker (2019) in their commentary on the initial OECD document. That is:

- d) an improved allocation of capital and therefore pro-growth.

We discuss these four possible objectives in turn.

#### *a) Address profit shifting*

The OECD's consultation documents on the GloBE proposal put the objective of addressing profit shifting front and centre. The proposal appears to have been a response to the fact that "certain members of the Inclusive Framework" believed the BEPS measures introduced in 2015 were insufficient, and considered that the BEPS "measures do not yet provide a comprehensive solution to the risks that continue to arise from structures that shift profit to entities subject to no or very low taxation" (OECD, 2019b, p.24).

Despite being included in a consultation nominally about the problems of the digitalisation of the economy, it has always been clear that the GloBE proposal is intended to be a form of super-charged provision of the BEPS process. The initial document stated: "This risk is particularly acute in connection with profits relating to intangibles, prevalent in the digital economy, but also in a broader context; for instance group entities that are financed with equity capital and generate profits, from intra-group financing or similar activities, that are subject to no or low taxes in the jurisdictions where those entities are established." (OECD, 2019b, p.24).

As already noted, the GloBE proposal seems to go much further than the aims of the BEPS project if they are taken to be addressing instances of "no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it". That is, the issue now appears to be no or low taxation per se, rather than no or low taxation in jurisdictions where there is little substance. In this subsection we focus on GloBE's aim of addressing profit shifting; we turn to this more ambitious aim in subsection (b) below. Countering profit shifting appears to be a straightforward and uncontroversial aim. But the meaning of 'profit shifting' is not obvious and merits further exploration. The notion of

shifting profit requires some explicit or implicit counterfactual. For example, subject to various provisions, the international tax system predominantly taxes royalty and interest payments in the hands of the recipient. If the recipient resides in a country with a low tax rate, then little tax will be due. Obviously this gives an incentive for multinationals to make such payments from high tax countries to low tax countries.

But that is an inevitable consequence of the existing system. If governments are not content with that system and regard the making of such payments to be profit shifting, then they should consider alternatives. Instead, the approach of the BEPS project, and now the GloBE proposal, is to introduce ad hoc measures to limit the extent to which profits are declared in low tax countries, but without changing the basic structure of the system. Both the income inclusion provision and tax on base eroding payments would introduce additional tax on income that is otherwise taxed at a low effective rate. But they attribute taxing rights to different countries.

In the example in Figure 1.1 above, C makes a royalty payment to B, in a low tax country. Let us suppose that the payment is at an arms' length price, that B legitimately owns an intangible asset, and that the payment is made for the use of that asset. Then, country C\* would normally recognise the royalty payment as a deductible cost. And the GloBE proposal would not intervene unless the effective tax rate in B were below a threshold (depending on the precise form in which the proposal is adopted). So the only reason country C\* might deny a deduction for the royalty payment is that the tax rate in B\* happens to be low. The same applies to country A\*.

Taxes levied in A\* and C\* are otherwise independent of the tax levied in B\*, so on the face of it, it is not clear why C\* should be concerned about the extent of taxation in B\*. Presumably it is believed that the multinational has deliberately set up its structure by having a subsidiary in B\* that owns the intangible asset to allow it to "shift profit" to B.

But the question then arises as to where the profit *should* be taxed. If the intangible asset were created by B in B\*, then the payment cannot reasonably be described as profit shifting. Similarly, if B simply purchased the asset at an arms' length price (which was also the "correct" price) from a separate company D (whether or not related), then again arguably there is no profit shifting. We might consider there to have been profit shifting if D had not paid appropriate tax on the sale to B, but that does not address the appropriate treatment of the royalty payment. This example also shows that the that GloBE could extend beyond profit shifting even if a substance carve-out were to be introduced. Whether it would depends on the exact wording of the carve-out. A substance carve-out might not prevent the operation of the GloBE rules in this example because there may not be sufficient substance in B if it merely purchases the intangible (albeit at the "correct" price) from D.

The point here is that, in the context of the way that the international tax system has been designed, whether we regard profit as having been shifted to B should depend on how the intangible asset has come to be owned by B, in a low tax country B\*. Neither of the two elements of the GloBE proposal addresses this issue directly. Instead, they both address it indirectly, by reducing the incentive for the asset to be owned in B\*.

This illustrates a common, and classic, approach in tax policy. Instead of directly aiming to correct a problem in the tax system, policy makers instead introduce some offsetting provision. That may help in some circumstances but is not likely to be appropriate in all circumstances. We consider below whether the GloBE proposal would be effective, and whether there may be better options.

*b) Address tax competition*

The OECD's February 2019 document states that "global action is needed to stop a harmful race to the bottom, which otherwise risks shifting taxes to fund public goods onto less mobile bases including labour and consumption, effectively undermining the tax sovereignty of nations and their elected legislators" (OECD 2019b, p.24).

The reductions in rates of tax on corporate profit in most countries over the last two to three decades have been well documented. There is considerable empirical evidence that these reductions in rates are at least partly the result of competition between national governments to attract real economic activity and mobile profit.<sup>11</sup> This is despite many countries – partly in response to the BEPS proposals – having also implemented many forms of anti-avoidance rules at the same time as competing on other aspects of their tax systems.

Corporation tax revenues have not fallen as strongly, but this is likely to be for a range of reasons. For example, many countries have broadened their corporate tax bases during this period, and as a result of broader, macroeconomic reasons the balance of returns has been shifting away from labour to the owners of capital.

There is little doubt that governments feel constrained in the effective tax rates that they can levy on the profit of multinationals operating within their jurisdiction. Some have argued that this creates a welcome constraint on the size of government. But even if that were desirable, it is unlikely to be true. Instead, as the quotation from the OECD above suggests, governments will have to raise their desired tax revenue from other sources.

From the perspective of economic efficiency, using other sources of revenue would be harmful if the alternative taxes generated greater economic inefficiencies than the tax on profit that they replaced. There is not unambiguous evidence on this issue. However, there is more broadly a great deal of evidence on the distortions created by existing taxes on profit and other taxes. That evidence identifies source-based taxes on profit as being particularly harmful. In that sense, the OECD's reference to shifting taxes to "less mobile bases"<sup>12</sup> is puzzling, at least from the perspective of economic efficiency. Other things being equal, taxing a less mobile base would tend to result in lower costs due to economic inefficiencies.<sup>13</sup>

It might be countered that it may be unfair to tax less mobile tax bases. But that is not clear either. To understand that we have to consider the incidence of a tax - that is, who is actually worse off as a result of the tax being levied? The owners of mobile factors of production are

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<sup>11</sup> For a survey see Devereux and Loretz (2013).

<sup>12</sup> OECD 2019b, p.24.

<sup>13</sup> Of course, other things may not be equal. Distortions to labour supply from income taxes depend on the specifics of the income tax, just as distortions from profit taxes depend on the specifics of the profit taxes.



less likely to end up bearing the incidence of the tax, even if the tax is nominally levied on that mobile factor. That is because the factor can move elsewhere to escape the tax, and in doing so, will cause prices to change, affecting the welfare of other economic agents. The classic example is a source-based tax applied to perfectly mobile capital. The owner of the capital would not accept a lower rate of return from investing in country X simply because X has a high tax rate on capital located in that country. Instead, she would only invest in X if she could earn a higher pre-tax rate of return, enabling her to receive the required rate of return after tax. That higher return must be generated at the expense of immobile factors, such as labour and customers.<sup>14</sup> One key lesson of economic theory is that immobile factors tend to bear the incidence of taxes, irrespective of how the tax is levied.

Nevertheless, competition clearly acts as a constraint on the sovereignty of governments to choose what they believe is an appropriate tax policy. Tax competition threatens the long-term viability of the existing system, as countries compete with one another in a race to the bottom. We discuss below the extent to which the GloBE proposals might be successful in diminishing tax competition.

*c) Stop proliferation of uncoordinated anti-avoidance measures*

The OECD's third justification is "that in the absence of multilateral action there is a risk of uncoordinated, unilateral action, both to attract more tax base and to protect existing tax base, with adverse consequences for all countries, large and small, developed and developing ... Unilateral measures taken in response can lead to double taxation and may even result in new forms of protectionism. Developing countries, often with smaller markets, may also lose in such a race and become even more dependent on natural resource taxation to finance their public needs, while multiplying tax free zones and other incentives to attract foreign direct investment" (OECD 2019b, p.24).

This statement covers a number of rather different points. There is clearly a risk of unilateral action on taxing the digitalised sector in particular, as is clearly the case since many countries have introduced, or proposed to introduce, new Digital Service Taxes (DSTs). In addition, countries already have many forms of anti-avoidance rules, which are not necessarily well coordinated with each other. That could lead to two or more countries attempting to tax the same profit, which – other things being equal - is not desirable. So as an aim, preventing uncoordinated action thus seems reasonable; whether the GloBE proposal would achieve this aim is a different issue, which we address below.

The comments about developing countries seem to assume that in the absence of coordination, tax bases will gravitate to market countries. The implication that developing countries would lose from such a race is not consistent with the latest empirical evidence, however. There seems to be a leap from identifying low income countries as having small markets to believing that they would necessarily do worse from a reform that moved taxing rights to market countries. This simply does not follow. Low income countries already have a small share of revenues from taxing profit, for a variety of reasons including the fact that less profitable real economic activity takes place in such countries, and that they find it harder to

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<sup>14</sup> See Gordon (1986).

combat tax competition. The evidence suggests that moving taxing rights to market countries would mostly be beneficial for low income countries.<sup>15</sup>

The final point that there may be a multiplying of tax free zones seems a response to tax competition, which we have addressed in (b) above.

*d) Improve allocation of capital and therefore pro-growth*

A fourth aim of the GloBE proposal – or at least a benefit claimed – has been put forward by Englisch and Becker (2019). They argue that the GloBE proposal would be “growth-enhancing”.<sup>16</sup> The reason that they give is that, if implemented, the proposal would lead to a smaller distribution of effective tax rates for multinationals amongst different options as to where to locate their real economic activities. The smaller the distribution of effective tax rates facing a given multinational, the less likely it is that tax will distort the location decisions of a multinational. As a result, investment will be more efficiently allocated amongst countries.

We analyse this at length in Section 3. There we consider the case of a multinational that locates a real investment project in one country and is able to shift part of the resulting profit to a low tax country. Depending on how it is introduced, the income inclusion rule may reduce the benefits of profit shifting, leading the multinational to shift less profit. That would raise the overall effective tax rate faced by the multinational on that investment. In general, raising the effective tax rate will tend to reduce overall investment. This consequence would therefore tend to diminish, rather than enhance, growth.

But the Englisch and Becker argument is that effective tax rates across alternative possible locations will become more similar to each other, and so improve the allocation of capital. If that is true, then there would be a positive economic efficiency effect to offset the cost of the higher effective tax rate. We analyse that possibility in detail below.<sup>17</sup>

Another type of distortion may also arise if some countries did not implement the income inclusion rule. That is, multinationals may have an incentive to shift their parent companies to countries that did not implement the proposal, thereby avoiding the additional tax liability. The extent to which they may be able to do so depends on the existence of anti-inversion rules and possible exit taxes. But these would not apply to new businesses, and so there would be an incentive to set up new businesses in such countries. The base eroding payments rule appears to be in part designed to counter these incentives; but, as discussed below, it is not clear that it could do so successfully.

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<sup>15</sup> See Hebous et al (2019), Beer et al (2019) and Devereux et al (2020). An assumption here is that countries continue to tax returns from the exploitation of domestic natural resources.

<sup>16</sup> Englisch and Becker (2019), page 7.

<sup>17</sup> Note here, though, that it is not necessarily true. Take the extreme case in which all profit is previously shifted to a zero-rated tax haven, for example. Then no tax would be paid on the returns to the investment, and so there would be no distortion to location decisions.

#### 4. Can the GLOBE achieve its objectives?

We now turn to a discussion of whether the GloBE proposal is likely to be successful in meeting its objectives.

A starting point is to note that the claimed benefits in terms of profit shifting and tax competition depend on it being adopted widely, if not universally. We ask whether this is likely to be the case, and whether - even if all, or most, countries agree to implement it initially - it could be stable in the long run, given incentive of individual countries not to implement it. We then consider the need for coordination amongst countries implementing the proposal and discuss some of the more pressing issues surrounding such coordination. Finally, we analyse the properties - and problems - of the system even if it were implemented universally and in a coordinated way.<sup>18</sup>

##### *a) The need for widespread adoption*

The need for coordination stems from the necessarily limited features of the proposal. The *inclusion of income* rule gives taxing rights to countries in which parent companies reside. The *tax on base eroding payments* rule gives taxing rights to countries from which payments are made.

But suppose that one country, Z\*, chooses not to implement the proposal. From the perspective of a multinational seeking to shift profit, it may seek either to move its parent to country Z\* or to shift to making payments from country Z\*. To think through the options, let us return to the example in Figure 1.1. A parent, P, resident in P\*, owns a subsidiary, A, in A\*, which in turn owns a subsidiary, B, in B\*. P also owns a subsidiary, C, in C\*, and C makes a royalty payment to B. B\* is a low tax country, with an effective tax rate below the minimum threshold.

Suppose that the income inclusion rule is levied in country P\*. Then, after the implementation of the income inclusion rule in country P\*, there would be an incentive for the company to shift its parent to Z\*. This may be limited by anti-inversion rules, or an exit charge. But that would not prevent new businesses choosing to locate in Z\*. And it would add further complexity to the system to define what might be acceptable acquisition by a company in Z\*, and what is not permitted. But suppose that P becomes owned by a parent Z, located in Z\*. Then, if the GloBE operates only at the level of the ultimate parent, any additional income inclusion charge would be avoided. Alternatively, suppose that the GloBE income inclusion charge could be levied at any level of the parent, including by Z\*, P\* or A\*. In this case to avoid the GloBE charge, B would have to be owned directly by Z. In that case, neither P\* nor A\* would be direct or indirect parents of B, and so the GloBE income inclusion charge would be avoided.

That restructuring still leaves country C\* able to deny a deduction for the payment made to B. That charge is perhaps more difficult to get around. One obvious possibility would be for the payment to be routed via Z\*. If Z\* itself had an effective tax rate above the minimum

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<sup>18</sup> See Junge et. al. (2019) for a detailed discussion of design choices in developing foreign minimum taxes.

threshold, then a payment to Z\* would not automatically be subject to a GloBE charge on the base eroding payment. But if the payment were taxed in Z\*, then the tax benefit of holding the IP in B would be undone. If instead that payment was passed onto B, it is possible that the tax authority in C\* would seek to look through the payment, deem it to have been paid to B, and implement the tax on the base eroding payment. That may be difficult in practice, of course, for example, if Z mixed various types of income from different sources and made a payment of a different form to B. More generally, however, the multinational would have an incentive to move its activities from C\* to Z\*.

At the least though, implementation of the GloBE proposal would be made considerably more difficult, complex and uncertain by the existence of some countries that did not implement it. This is particularly true of the income inclusion rule, but also applies to the charge on base eroding payments.

### *Incentive compatibility*

Would there be an incentive for a country not to implement the GloBE? Surely the answer is yes. The evidence of the last three decades is of tax competition between governments to attract inward investment by multinational businesses. It is hard to see why that competitive process should be suddenly abandoned.

Suppose there was agreement amongst a number of countries to implement the GloBE proposal. What incentive would there be for another country – say Z\* - to implement it as well?

On the one hand it may generate some additional tax revenue for Z\*. This may not materialise, however. Universal introduction would mean that there would be no incentive for any country to have an effective tax rate below the minimum threshold. Countries with tax rates below the threshold could therefore be expected to raise their tax rates up to the level of the threshold. In this case, country Z\* would not necessarily generate any additional tax revenue. It may generate additional revenue to the extent that the rise in tax rates in low tax countries induced multinationals located in Z\* to shift less profit out of the country. That would represent some benefit to Z\* from implementing the GloBE, and we discuss this possibility in greater detail below.

On the other hand, not implementing the GloBE would make Z\* an attractive place for parent and headquarter companies to locate. It would also make it an attractive location for say manufacturing activities that would involve paying a royalty for the use of intangible assets owned in a low tax country. Given that many countries have clearly paid a price in terms of lower tax revenue in order to attempt to attract new business, these factors can be expected to be a powerful influence on Z\*'s choice of whether to implement the GloBE proposal.

Devereux et al (2020) set out five criteria for evaluating a tax on business profit. One of these is incentive compatibility; under a good international tax system, no country would have an incentive to diverge away from that system. They argue that the existence of tax competition is a clear sign that the existing system does not exhibit incentive compatibility. As countries compete they impose costs on other countries, either by shifting investment away from other

countries, or by forcing them to reduce their tax rates. The same would appear to apply to the GloBE proposal. Even if a country like Z\* agreed to implement the GloBE proposal initially, it might always have an incentive at some point in the future – perhaps under a new government – to renege on the agreement, and to abandon its implementation. But the same is true of all countries; it is hard to believe that there could be a long-term equilibrium in which all countries implemented the GloBE, whilst many had an incentive not to do so.

It might be thought that the tax on base eroding payments may force countries to comply with the GloBE proposal, since payments made to companies located there may not receive a deduction in the country the payment is made from. But that is not at all clear.

We can reorganise (and simplify) the example given in Figure 1.1. to explore this issue. Suppose that Z is resident in Z\* which does not operate an income inclusion rule but has a tax rate above the minimum threshold. Z has a subsidiary, B, in B\*, which has a tax rate below the minimum threshold. Z has a second subsidiary, C, in C\* a high tax jurisdiction which adopts the GloBE. C undertakes manufacturing activities and pays B a royalty for the use of IP held there.

Would the tax on base eroding payments rule in C\* compel Z\* to adopt the GloBE proposal? Denying the deduction for the payment from C to B would undo the benefit of locating the IP in a low tax country such as B\*, therefore, it might be thought that this would give B\* an incentive to increase its tax rate up to the threshold. But it would also give an incentive to the multinational to move its manufacturing from C\* to Z\* or even B\*. In that case, B\* would keep its low tax rate and C\* would lose the real activities to Z\* or B\*. In this light, the tax on base erosion payments could be seen to strengthen the incentives for C\* not to introduce the GloBE.

But what if C\* is a significant market, and, therefore, the multinational is unlikely to want to forfeit the opportunity of selling goods to consumers there? Could the tax on base eroding payments rule then provide an effective incentive to Z\* to adopt the GloBE and B\* to increase its tax rate to the minimum threshold? Let's assume the goods are produced by Z and sold to C in C\* which then sells them to consumers there. A tax on base eroding payments rule could be drafted broadly to deny a deduction for the purchase of the goods by C; this would effectively be a tariff. But in this example the tax rate in Z\* is not below the threshold and therefore the payment would not be caught even if Z paid significant royalties to B thus shifting profit there. An attempt could be made to take into account the royalty payment by Z to B when calculating Z's effective tax rate but that would involve significant complexity and difficulty.

But let's further assume that the tax on base erosion payment rule can somehow take into account the royalty payment from Z to B. In that case the deduction in C\* for the payment from C to Z would be denied. Even then, however, Z would have an obvious planning opportunity – selling the goods to consumers in C\* through an independent distributor

there.<sup>19</sup> As the base on tax erosion payments rule would presumably only apply to related party transactions, this would circumvent the rule.

In conclusion, it is not at all clear that tax on base erosion payments rules can be designed to create incentives for uncollaborative countries to adopt the GloBE. This is so even if it is a strong version of the rule which harnesses some of the strengths of a destination based approach.

As a way of implementing a minimum tax throughout the world, the GloBE proposal is rather indirect. Why not simply propose a minimum tax directly: that no country should have an effective tax rate below an agreed minimum threshold? The answer is presumably that it would be expected that some countries would not agree. If they were somehow forced to do so, perhaps through a rule similar to the tax on base eroding payments, then they could reasonably argue that this would be a contravention of their sovereignty. But this seems to be the intended effect of the GloBE proposal. As such, it seems to go far beyond the principles of the BEPS project.

The various consultation documents are sensitive to this issue and insist that this proposal: “leaves jurisdictions free to determine their own tax system, including whether they have a corporate income tax and where they set their tax rates” (OECD, 2019e, p. 28). Some members of the Inclusive Framework appear to have raised some justifiable scepticism and “are of the view that the rules explored within this pillar may affect the sovereignty of jurisdictions that for a variety of reasons have no or low corporate taxes in particular where they target income arising from substantive activities.” (OECD, 2019e, p. 36).

If countries were not forced to implement the GloBE proposal, then it seems likely that at least some would choose not to do so. And that could fundamentally undermine the aims of the proposal.

### *The need for harmonisation*

The need to cooperate in introducing the GloBE proposal goes far beyond simply agreeing to introduce it. It is also necessary to agree a harmonised form. For example, suppose that there were no agreement on the measurement of the effective tax rate, or its minimum threshold. Then countries could compete with each other on either of these dimensions; for example, one country could gain a competitive advantage by setting the threshold below that set by other countries. That would be a classic form of tax competition and underlines the need for cooperation on a single threshold rate. Furthermore, agreement on a weak form of the GloBE proposal would not achieve its objectives, or at least not very well. Coordination and harmonisation are thus crucial, but so is the detail of what is agreed.

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<sup>19</sup> This problem also arises in the context of other reform proposals such as sales-based formulary apportionment and Residual Profit Allocation systems. Note that the problem is less severe under a Residual Profit Allocation by Income system, because only the residual profit that is allocated on a destination basis. The problem does not arise under a Destination Based Cash Flow Tax.

## *b) Measuring the effective tax rate*

One critical issue in the design of the GloBE proposal is the measurement of the “effective tax rate”. This is a critical value for the GloBE; having an effective tax rate below the threshold triggers the implementation of any additional tax charge.

### *Alternative bases*

There are at least three options for measuring the effective tax rate. First, it would be possible to use taxable profit in the host country. If this were literally the base used (and it is positive), then the effective tax rate would be simply the statutory tax rate. This has the merit of simplicity, but as we discuss below, that may give an incentive to the host country to introduce reliefs and allowances that create a smaller tax base.

It is possible that the GloBE could be based initially on the host country tax base, but with some adjustments. However, any adjustments could inhibit the host country in its choice of tax base even irrespective of any aim to get around being subject to the GloBE. For example, suppose that the country decided that its tax base should be only economic rent; this is a perfectly credible position, advocated for decades by economists.<sup>20</sup> But, it is possible that any such diminution of the tax base could be undone by the GloBE proposal.

Second, it would be possible to use the rules for determining taxable profit in the country of the parent. This has the merit of addressing directly what may be seen by the parent country as profit shifting. And this is the basis on which several countries operate their CFC rules. On the other hand, this would clearly create a very significant administrative burden, especially if the threshold operated on an entity-by-entity, or country-by-country basis. This would also clearly inhibit any legitimate choice of tax base by low tax countries.

Third, and with these disadvantages in mind, OECD (2019e) considers using accounting rules to determine the effective tax rate. The denominator would be accounting profit “subject to any agreed adjustments”. The numerator “could be based on the actual tax liability of the tax expense accrued for accounting purposes, which may need to be further adjusted to remove accruals of tax related to a different period” (page 9). This approach raises a number of issues.

### *The use of financial accounts*

To begin with, it implies that the accounting measure of profit is a better measure than taxable profit in the country in question. As noted above, if the numerator were the tax charge, and the denominator were simply taxable profit in the host country, then – at least in the absence of losses and tax credits - the effective tax rate should be equal to the statutory tax rate. So differences between the effective tax rate and the statutory tax rate will primarily be driven by differences between taxable profit and the profit declared in financial accounts. Presumably the concern is that the government of the host country may “artificially” reduce taxable profit by permitting special reliefs or allowances. But this concern would suggest

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<sup>20</sup> See, for example, the Meade Committee (1978).

starting from the host country tax base and making a correction for any such reliefs or allowances; it does not obviously support using an entirely different measure.

As OECD (2019e) acknowledges, taxable and accounting profit are different for many reasons, both permanent (for example, whether or not some business expenses are tax deductible) and temporary (for example, more or less generous treatment of depreciation). In principle, these differences could result in accounting profit being higher or lower than taxable profit. For example, the non-deductibility for taxation of some expenses would result in taxable profit being higher than accounting profit, generating an effective tax rate based on accounting profit being higher than the statutory rate.

The notion that the numbers in consolidated financial accounts represent something closer to ‘real profit’ than the figures produced by corporate taxpayers for tax purposes is apparent in many of the analyses produced by commentators over the past few years. The use of an effective tax rate figure (ETR) based on pre-tax earnings from financial accounts is regularly accompanied by caveats to the effect that a low ETR relative to the statutory rate does not necessarily prove that avoidance, base erosion, or profit shifting has taken place, yet discrepancies between the ETR and the statutory rate are nevertheless frequently seen as indicators that something is amiss in terms of the amount of tax being paid by an MNE, and are seen as a risk factor by revenue authorities in their risk assessments as well as by researchers and commentators.

But, as noted, the differences can be due to many factors, including allowances and reliefs legitimately provided by governments. And the figures in financial accounts are far from uncontroversial or straightforward.<sup>21</sup> A range of numbers is often possible within financial accounts and notes to the accounts are crucial to analysts. But tax authorities need a single figure on which to base taxation, making the use of financial accounts less useful for tax purposes. Financial reporting has different objectives from tax accounts, aiming to provide a range of information for stakeholders. If accounting rules became determinative for taxation purposes, there would be a danger that pressure would start to be exerted on accounting standard setters to change the rules to make them more prudent and, for example, slower to recognise unrealised profit. This might make sense for tax purposes but could slow down the speed at which information would come to the market, a priority for financial reporting to a range of shareholders. In other words, tax considerations could threaten to pollute the accounting standard setting process.

The OECD’s rationale for considering financial accounts is explicitly to “neutralise the impact of structural differences in the calculation of the tax base”.<sup>22</sup> This clearly, and quite deliberately, would remove the freedom of the host country to provide tax incentives, accelerated depreciation and other favourable tax rules.

Those drafting the EU’s Common Consolidated Corporate Tax Base (CCCTB) met with a similar challenge of finding a common base, but they moved away from the use of International Financial Reporting Standards (IFRS) as a result of the practical, theoretical and constitutional

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<sup>21</sup> See Quattrone (2019).

<sup>22</sup> OECD (2019e), para 15.



challenges posed by adoption of those standards as a starting point for taxation.<sup>23</sup> The challenges of using financial reporting standards at a global level are likely to be even greater, given that not all jurisdictions use the same accounting standards and not all multinationals prepare consolidated accounts. Despite all attempts at convergence between IFRS and US GAAP, for example, important differences remain. This raises the question of whether forum shopping might turn from being based on tax systems to being influenced by the accounting standards of the ultimate parent entity, were that to determine the tax base.

Using financial accounting or tax purposes also raises constitutional issues, which proved to be a stumbling block in discussions of the CCCTB. The International Accounting Standards Board and the Financial Accounting Standards Board in the USA are both not-for-profit corporations and, despite attempts to make them representative and accountable they are not government bodies under the supervision of elected legislatures. They may well be vulnerable to pressure from their users.<sup>24</sup> Although existing tax systems already rely on financial accounts to a significant extent, governments may well be reluctant to hand over more control of the tax base to these bodies, and there could be constitutional challenges if they do so.

This might mean that it would be seen to be necessary to allow adjustments to be made to take account of permanent and temporary differences between the income computed under financial accounting standards and under the tax rules of a particular country, an option discussed in the consultation document. This would be complex, as illustrated in the OECD document, and also potentially open to abuse. Moreover, it could reduce the income to which the minimum tax relates and thus undermine the concept of the common base to which the global rate should apply.

#### *Common problem of identifying “true” profit*

Moreover, it is far from clear that using an accounting-based measure helps to identify profit shifting. Suppose that a multinational has “true” profit of £100 in country A\*, but that it is able to “shift” £30 of this to a country with a zero rate of tax on profit. The shifting could come in the form of a royalty payment, interest payment, or a mispricing of the purchase or sale of a good or service. In all these cases, taxable profit in A\* would fall to £70. But there is no reason to suppose that the declared accounting profit would be different from £70. Other things being equal, then, the measured effective tax rate in A\* would still equal the statutory tax rate.

This is a significant problem in identifying some “true” measure of profit in a country from which profit is shifted, which is an important issue in the context of the country-by-country implementation of the GloBE, as discussed below. To make this more concrete, suppose in the example that the multinational instead shifted £75 out of A\* to a low tax country, and suppose that the statutory tax rate in A\* is 20%. Then there would be taxable profit of £25 in A\*, and a tax liability of £5. Relative to the “true” measure of profit in A\*, this would represent an effective tax rate of 5% - probably below the minimum threshold for the GloBE. But the

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<sup>23</sup> Freedman (2008).

<sup>24</sup> Herzfeld (2019).

measured effective tax rate would be 20% - probably above the minimum threshold for the GloBE.

It is not clear that any of the alternative measures of the effective tax rate in A\* would address this problem. That is because the problem arises relative to some unknown counterfactual. Observed profit is £25. But “true” profit is unknown. The blended form of implementation of the GloBE would, however, not suffer from this problem. We now turn to discussing this option.

#### *c) Blending*

A key issue in the determination of the GloBE proposal is whether it should be implemented on the basis of an individual entity, a country, or for the entire foreign activities of a multinational. The empirical evidence in the next two sections addresses the choice between implementing the GloBE on a country-by-country basis, or “blending” taxable income of a single multinational across all countries outside that of the parent, assessing the impact on incentives and on likely revenues. The issue is addressed by the OECD in its November 2019 Consultation Document (2019e), where many points are raised. The choice between these options reflects a trade-off between the aims of the proposal and the complexities involved in implementing it.

If the aim is to set a floor to effective tax rates throughout the world, then the blending approach is unlikely to be very successful. That is because multinationals could still make use of zero-tax rate jurisdictions. For example, if the threshold is set at 10%, then, a multinational could shift half of its profit from a country with a 20% rate to a country with a zero rate and still meet the GloBE’s threshold requirement. There would therefore still be some benefit to the multinational of being able to shift to a zero-rate country (assuming that some countries maintained rates above the threshold), and presumably some gain to that jurisdiction from maintaining its zero rate. This clearly would not apply under a country-by-country approach; then the zero-rate country may as well raise its rate up to the threshold.

A country-by-country approach is also likely to have a larger impact on profit shifting, essentially for the same reason. If the zero-tax rate country raises its rate to 10% - or if the income there is taxed at 10% by the country of the parent – then the gain from shifting profit there is diminished. This is demonstrated in more detail below in Section 3.

On the other hand, implementing the GloBE on a country-by-country basis would require the determination of both profit and the existing effective tax rate in each jurisdiction in which a multinational operates. The profit generated in each jurisdiction would depend on any methods that the multinational has chosen to shift profit to lower taxed countries. This would result in greater administrative costs, greater complexity and probably greater uncertainty.

#### *d) Carve-outs*

We have discussed substance-based carve-outs above. This is a critical issue. Introducing the GloBE proposal without a general substance-based carve-out constitutes a fundamental departure from the rhetoric and apparent principles that dominated the international tax

debates only very recently. It can also be perceived – and appears to be so perceived by some countries – as denting countries’ tax sovereignty. It would effectively mean that countries are not free to choose to tax the profit generated by real activities within their borders at the rate of their choosing. It might be countered that some countries are currently pressured to tax this profit at a low rate, whether directly by taxpayers or indirectly through tax competition. That may well be true. But it is equally possible that other countries are content to give up their tax revenues in return for real activities, particularly if they have limited non-tax benefits to offer to attract investment to them rather than their competitors. The GloBE proposal would effectively take this option away from them. It is possible that the current position is not sustainable in the long run if competition eventually drives rates down to zero, or close to zero. However, it seems likely that these countries would not give up the benefits of being able to choose a lower tax rate in the shorter run voluntarily.

On the other hand, and as argued above, if the GloBE proposal is to attain its second objective – addressing tax competition – it cannot include a substance-based carve-out.

More targeted carve-outs may be sought in negotiation. For example, one country may seek a carve-out for the profits of businesses in the tourism industry, and another in its agriculture. These countries may argue that these carve-outs are necessary to develop or support industries that are vital for their economies. The problem, of course, is that most, if not all, countries around the negotiating table may have such concerns - and if coordination is achieved only with such specific carve-outs, then the proposal would be significantly weakened. A proliferation of carve-outs would increase complexity and avoidance opportunities and would decrease neutrality.

*e) Remaining issues even if implemented “perfectly”*

The conclusion reached above is that to achieve its two main objectives well, as a minimum, the GloBE proposal must be adopted very broadly, if not universally and it must be a harmonised, strong form GloBE without substance carve-outs and blending. Even then, it is not clear that some technical issues, such as those involved in the calculation of ETRs, can be solved. Furthermore, it appears unlikely that that this level of agreement can be achieved politically. But even if it is achieved, a number of concerns remain. We note four here.

First, the GloBE proposal is not incentive compatible, in the sense that there is an incentive for at least some countries not to agree to the GloBE proposal voluntarily. In that case, political pressure may be applied to them to ensure that the GloBE proposal is initially adopted universally or almost so. But there will always be an incentive for individual countries to defect from the agreement, in order to attract business. That threat will continue to hang over the system and is likely ultimately to undermine it. The key reason is the reliance on taxing in the jurisdiction of the parent company, which is ultimately mobile.

Second, the GloBE proposal does not seek to eliminate profit shifting and tax competition, but merely places an arbitrary floor for effective tax rates. So even if a country-by-country form of the GloBE proposal were adopted universally, it is likely that profit-shifting and tax competition would remain as long as countries have corporate tax rates on a source basis that are higher than the agreed minimum threshold. In the case of the GloBE being introduced in

a form of blending by each multinational, the reduction in competitive pressures would be significantly lower, as we set out in more detail below.

Third, the GloBE proposal would deny low tax countries (and possibly even countries with higher tax rates) the option of choosing a tax base that is different from that chosen from the GloBE proposal. While that may be useful in some cases as a step towards reducing competition over tax incentives, it may also rule out perfectly reasonable policies – for example, limiting the tax base to economic rent through the use of an Allowance for Corporate Equity, or offering incentives for research and development. This could perhaps be addressed to some extent by permitting some deviations from the GloBE tax base, but this would require a definition of what is acceptable and in what circumstances, certainly leading to even greater complexity.

Fourth, the proposal would introduce a range of new measures in the international tax system that would inevitably lead to yet another increase in complexity, as well as in compliance and administrative costs. Difficulties would inevitably arise in the context of defining the appropriate base for the GloBE calculations. And if introduced on a country-by-country basis, then the allocation of profit to each jurisdiction would still depend on existing transfer pricing rules. The GloBE proposal would do little, if anything, to reduce existing complexities.

## **5. Would other reform options achieve these objectives more successfully?**

The case has recently been made for moving towards a destination basis of taxation – that is the taxation of profit in the market country, where sales are made to independent third parties. There are a spectrum of options here, ranging from the unified approach under the OECD Secretariat’s Pillar I proposal,<sup>25</sup> to a more general form of Residual Profit Allocation system,<sup>26</sup> to a Destination Based Cash Flow Tax.<sup>27</sup> We do not discuss these options at length here, but we do note two important points.<sup>28</sup>

First, a destination-based tax system has the potential to achieve the objectives set out for the GloBE more successfully. The rationale for taxing business on a destination basis is intuitive. Businesses can move their headquarters, real activities, intellectual property, borrowing and almost all other factors. But under a pure destination-based system, doing so would not affect their aggregate tax liabilities. Instead, their liabilities would be determined by the location of their consumers, which businesses – by and large – cannot control.

As a result, destination-based taxes perform well under reasonable criteria. Under a pure destination-based system, businesses would have no incentive to move their real activity – thus removing economic distortions. Profit shifting opportunities would be reduced, or even eliminated, because the location of IP, borrowing, risk and other factors that are currently

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<sup>25</sup> OECD (2019d).

<sup>26</sup> Devereux et al (2019, 2020).

<sup>27</sup> Auerbach et al (2017) and Devereux et al (2020).

<sup>28</sup> These issues are spelt out at length by Devereux et al (2020).

employed strategically in profit shifting practices, would be inconsequential for tax purposes. In turn, this should also reduce the need for complex legislation and administrative costs.

Second, destination-based systems – depending on their design – are incentive compatible in the sense that countries have an incentive to move to a destination-based system. This is a very significant benefit over the GloBE, as it means that universal adoption and coordination are not required. Countries would not have an incentive to reduce their tax rates as this would not attract real activities or profit, meaning that competitive pressures would ease, or disappear altogether. But more generally, if some countries unilaterally moved towards a destination basis of taxation, other countries would have an incentive to do likewise, rather than to choose an alternative approach.

## **PART 2. Evidence of the Revenue Implications of the GloBE**

We now turn to estimating the revenue impacts of introducing the GloBE proposal, or more specifically, the income inclusion rule. We begin by considering the effects of introducing the income inclusion rule on a country-by-country basis, and then move onto the blended option, treating a multinational as a single entity.

We make a number of important assumptions in analysing the available data, as we set out below. First, we assume that the income inclusion rule is introduced universally, with agreed definitions and an agreed threshold for effective tax rates. Second, we assume that there is no carve-out rule; so that all profit taxed at an effective rate below the threshold would be subject to additional tax. Third, we do not attempt to account for any behavioural responses of multinationals or governments to the introduction of the income inclusion rule. So we do not account for factors such as a change in intensity of profit shifting, or the choice of location of real activity. Nor do we allow countries to respond by changing tax rates. This is not because we believe that there will be no behavioural response, but rather simply that estimating revenue effects is already complex even ignoring behavioural effects; adding behavioural consequences is beyond the scope of this study.

Fourth, it should be noted that the analysis does not take into account existing taxes levied at the parent company level, such as those based on CFC rules, or the US GILTI minimum tax provision, introduced from 2018. The GILTI provision ensures a minimum tax rate of 10.5% on that part of the foreign income that comes from intangible assets. Our data is not recent enough to be able to estimate the additional revenue if the US implemented the income inclusion rule, relative to its revenue from the GILTI. Instead, we estimate the impact of the income inclusion rule relative to the position of the US in earlier years, in particular 2015. The Joint Committee for Taxation (2017) estimated that the GILTI provision would raise \$9 billion. Estimates for the US from implementing the income inclusion rule should therefore be seen relative to this.

### *Data*

We combine three sources of data for the country-by-country implementation of the income inclusion rule, and two others for the blended implementation.

First, for the country-by-country approach, we use estimates of the aggregate profits of, and income taxes paid by, foreign multinationals located in each country. These estimates initially come from Tørsløv et al. (2018), based in turn on data from national accounts. These data are available for 78 individual countries (these include OECD countries, large developing countries, and non-OECD tax “havens”); we also have data aggregated for the rest of the world. This dataset describes the position in 2015. It is based on several sources of official statistics, including national accounts and foreign affiliate statistics.

We make some adjustments to these data, based primarily on the analysis of Blouin and Robinson (2019). Essentially, there are generally two estimates of the size of the aggregate profit of subsidiaries of foreign-owned companies in a country. One is based on host country data. The other is based on data from the country of the ultimate parent. Tørsløv et al. point out that there are large discrepancies between these two sources. They make “corrections” to reconcile the data, essentially assuming that the parent country data is more reliable. Blouin and Robinson point out, however, that these two sources of data may measure different variables and do so for the important case of US parents. Consider a US company with a subsidiary in country A, which in turn owns a subsidiary in country B. Blouin and Robinson point out that the US data for country A will include the profit of the subsidiary in B. This is an overstatement of the profit actually made in A. The US data are therefore not a reliable measure of the profit made by the subsidiary in A. In our Base Case, we therefore “un-correct” the corrections made by Tørsløv et al. with respect to US-based multinationals, and in these cases use the host country data.

That still leaves some uncertainty about the need to correct the other data. On the one hand Tørsløv et al present evidence that the host country data is not always accurate. On the other hand, it is likely that the problem with US data also applies to multinationals based in other countries. In our Base Case we follow the Tørsløv et al. “correction” in using data from the country of the parent where the parent is not in the US. As a robustness check, however, we also examine the case where no “correction” is made, and therefore use only the host country data.

Second, we use ORBIS data provided by Bureau von Dijk. This data set includes unconsolidated financial statements of subsidiaries of foreign-owned multinationals in 36 countries for 2012. Again, we use data on profit before tax and the tax charge to calculate the effective tax rate as the tax expense expressed as a proportion of profit before taxes. To account for the fact that ORBIS does not cover all foreign-owned subsidiaries in a particular country, we scale our ORBIS-based country-by-country estimates using the aggregate profit of foreign-owned corporations included in ORBIS and the aggregate profit data from Tørsløv et al. In doing so, we assume that the subsidiaries in ORBIS are representative of the whole population of foreign-owned businesses within a country.

Third, we aim to allocate the additional tax revenue generated by the country-by-country implementation of the income inclusion rule to countries of the parents, assuming that the additional revenue is collected by the country of the ultimate parent. We use data on bilateral direct investment statistics on an ultimate ownership basis compiled by Damgaard and Elkjaer (2017).<sup>29</sup>

For the estimation of the revenue consequences of the blended, multinational level approach to the income inclusion rule, we use two different datasets: COMPUSTAT and WORLDScope data. These include consolidated financial statements of publicly listed US and non-US companies, respectively. We use data on consolidated foreign profit and foreign income tax, enabling us to identify a measure of the accounting effective tax rate for foreign activities. As with ORBIS data, to provide full-population estimates, we scale the results based on the

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<sup>29</sup> These data are derived from OECD data on FDI with the IMF’s Coordinated Direct Investment Survey (CDIS).

aggregate size of foreign profit observed in the consolidated accounts relative to estimates from Tørsløv et al. of the aggregate size of foreign profits of MNEs headquartered in that country; the latter draws on ownership data as well as the profits of foreign owned corporations. Implicitly we assume that the foreign activities of publicly and non-publicly listed companies are comparable.

While the precision of each individual data source is on its own hard to assess, the combination of them in this project highlights two issues. First, we find that the aggregate profit of foreign-owned firms observed in ORBIS sometimes exceeds the aggregate profit of foreign owned corporations from the Tørsløv et al. data. There are at least two potential explanations for this. On the one hand, we may overestimate the amount of profit in ORBIS as we are not able to exclude dividends received from pre-tax profit, or to correct for the equity method of accounting for minority interests. On the other hand, the profit of foreign-owned corporations from Tørsløv et al. may be incorrect since foreign affiliates statistics are not available for several countries.

Second, using the Tørsløv et al. data and the ownership data we find much smaller estimates of the aggregate size of foreign profits of US multinationals. More precisely, US tax return data suggest the aggregate foreign profit of US multinationals in 2015 was \$650 billion.<sup>30</sup> Aggregating data from the consolidated accounts of listed US-based multinationals in 2015 from COMPUSTAT, we find \$491 billion of foreign profit. These estimates may be comparable, as the estimate from COMPUSTAT contains only listed companies. However, using the source country data of Tørsløv et al. and assigning it to parent companies using ownership data of Damgaard and Elkjaer (2017), we estimate aggregate foreign profit of US multinationals to be only \$235 billion. There is therefore a large discrepancy between these methods of estimating the total size of the foreign profit of US multinationals.

If the calculation error stems largely from the ownership data in the third approach, this would mean our estimate for the impact on global tax revenues under the country-by-country approach may be correct, but that we overestimate the revenue gains for non-US countries and underestimate the gains for the US. On the other hand, if the calculation error stems from an underestimate of foreign profits in the Tørsløv et al. data, then we would underestimate the additional tax revenue generated by the income inclusion rule proposal implemented on a country-by-country basis.

Comparing unconsolidated financial statements data for affiliates of European and US multinationals, we find that affiliates of US multinationals have a rate of profit (profit before taxes as a proportion of sales) around twice as high the affiliates of European multinationals and domestic firms. This suggests that the US-owned share of total foreign profit is higher than the US-owned share of FDI; using the ownership data based on the FDI data of Damgaard and Elkjaer (2017) may underestimate the ownership share of foreign profits of US MNE by around 50%. This factor might then explain almost 60% of the discrepancy in the first and third approaches described above in measuring the foreign profits of US MNE affiliates. We discuss this further below.

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<sup>30</sup> See Blouin and Robinson (2019).



## 1. Income inclusion rule implemented on a country-by-country basis

In this section we attempt to estimate the amount of additional tax revenue that would be raised if the income inclusion rule were introduced on a country-by-country basis. As noted at the beginning of this section, we assume that the income inclusion rule would be introduced universally and that there would be no substance carve-out, and we make no attempt to allow for behavioural responses to the introduction of the rule. Specifically, we assume that firms do not move their profits to other locations in response to this policy, and we assume that low-tax jurisdictions do not increase their tax rate to the level of the minimum tax threshold in order to attract all the extra revenue. In this sense these calculations should be interpreted as a benchmark against which potential responses can be considered.

### *a) Approach 1 - Using aggregate macro data only*

Our first approach uses the aggregate macro data originating from national accounts and compiled by Tørsløv et al. (2018), although with our own adjustments, as described above. For each country, we identify the aggregate size of profit of foreign-owned firms. We also identify the aggregate size of tax liabilities and calculate an effective tax rate (ETR); this is measured by aggregate tax expressed as a ratio of tax to aggregate pre-tax profit. We assume that the income inclusion rule would be triggered if the effective tax rate were below some threshold ETR. If it is, then we calculate the additional tax levied under the income inclusion rule as the threshold multiplied by aggregate pre-tax profit, less the existing tax liability.

Table 2.1 shows the results, assuming an ETR threshold of 10 percentage points. If the estimated ETR is above the threshold the revenue from the income inclusion rule is set to zero. Our baseline estimate using macro data only indicates additional global revenue of \$20 billion. This represents 9% of the taxes paid by foreign subsidiaries of multinationals, and 1.4% of their profit. It is 1.1% of total corporation taxes and 0.2% of total profit.

The second column presents the results of our robustness test, in which we use only host country data, as described above. The estimated revenue yield based on this approach is approximately half of the base case, at just over \$10 billion. This difference illustrates some of the uncertainties generated by differences between alternative data sources.

Note that both these approaches use aggregate data on profit, which means that it includes both profit-making and loss-making companies. This is problematic in that this approach implicitly nets out profit and losses, as if there were only one company in the whole country. In practice, of course, loss-making companies do not generally receive refunds, and so this approach is likely to understate the impact of the GloBE approach. On the other hand, the use of brought-forward loss carry-forwards may induce a bias in the opposite direction.

By using the overall country-level ETR, we also implicitly assume that all firms within a country have the same ETR. In practice, some firms may be above, and some below, the threshold. GloBE revenue would be collected from the latter even if on average firms were above the threshold. This may also lead to an underestimate of the GloBE revenue. For both these reasons, we now turn to allowing for some heterogeneity between firms.

<b>Table 2.1: Using macro data only</b>		
	<b>Base Case</b>	<b>Host country data</b>
	<b>\$ billion</b>	<b>\$ billion</b>
Total Tax Revenue	1,819	1,819
Tax Revenue: foreign controlled corporations	226	220
Total corporate profit	9,950	9,786
Total profit: foreign controlled corporations	1,447	1,238
<b>Revenue from income inclusion rule</b>	<b>20</b>	<b>10.4</b>
<b>Revenue as % of:</b>	<b>%</b>	<b>%</b>
Total Tax Revenue	1.1	0.6
Tax Revenue: foreign controlled corporations	9.0	4.8
Total corporate profit	0.2	0.1
Total profit: foreign controlled corporations	1.4	0.8

*b) Approach 2 – Combining macro and micro data*

To account for heterogeneity in tax rates within countries, we combine the above macro data used in Approach 1 with micro data from the ORBIS database.<sup>31</sup> Not all countries have comprehensive coverage of the unconsolidated accounts of foreign-owned firms; we are able to account for heterogeneity in only 32 countries.

A disadvantage of using the micro data is that we cannot verify the representativeness of the sample. If very large corporations have low tax rates within a country, but are not observed, then we are likely to underestimate the revenue that would be collected by the income inclusion rule. This is likely to be a reason for a small amount of revenue estimated for Ireland using this approach.

In each of these cases we calculate revenue from the income inclusion rule for each firm for a threshold ETR of 10%. We consider only firms with positive pre-tax profit. We aggregate these amounts for each country. We then scale the aggregate to account for the fact that ORBIS does not have comprehensive coverage. We scale by the fraction of aggregate pre-tax profit observed in our ORBIS sample relative to aggregate foreign profits in the National Accounts.<sup>32</sup> We then sum these scaled numbers across all countries. We present the results as a percentage of the total tax paid by foreign controlled corporations in national accounting data.

For countries with no, or insufficient, ORBIS data we simply use the aggregate approach described above. These countries include those that are important for this analysis, such as Bermuda, Bahamas and the Cayman Islands,

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<sup>31</sup> We use data from 2012, since we are using the 2013 database, and hence 2012 is the last year with comprehensive coverage.

<sup>32</sup> In scaling we sum across all corporations, including loss-making, to make it as comparable to the number reported in the national accounts as possible. We restrict this scaling factor to be between zero and one.

Table 2.2 shows the results of these two methods for different sample restrictions on the micro data. In all calculations we condition on foreign ownership and positive pretax profits. We further only consider countries for which we have more than 50 observations in ORBIS after other sample restrictions are made.

<b>Table 2.2: Combining micro and macro data</b>		
	<b>Base Case</b>	<b>Host country data</b>
	<b>percentage of taxes paid by foreign affiliates</b>	<b>percentage of taxes paid by foreign affiliates</b>
Positive tax	14.9	10.5
Positive tax, non-zero tangible fixed assets	13.4	8.9
Non-negative tax	16.2	11.8
Non-negative tax, non-zero tangible fixed assets	<b>14.0</b>	<b>9.5</b>

Our preferred specification includes all micro data on corporations with non-negative tax, positive profits and non-zero tangible fixed assets – the last line in Table 2.2. We remove companies with zero tangible fixed assets to make sure we are not including pure holding companies whose only income source is dividends. However, even with this restriction we can still not be completely sure that we are not including some dividend income in our calculations. This is a limitation of our approach.

With this approach, in our Base Case, and with these restrictions, our central estimate is that the income inclusion rule would raise about 14 percent of the existing corporate taxes paid by foreign controlled corporations. In aggregate this is around \$32 billion. In the alternative case of using only host country data, we estimate the income inclusion rule would raise around 9% of existing corporate taxes.

Of course, a number of caveats surround these estimates. There are many data limitations; in addition to those already set out, the precision of the estimates in the case of very low-tax jurisdictions should be treated with caution. Other problems arise from more specific issues, such as a low observed ETR because the firm is bringing forward a taxable loss. This raises issues about how the income inclusion rule would deal with losses. In our micro data we can test to some extent whether this issue is important by disregarding corporations with losses in the year before our analysis. These estimates are very close to those reported above, and hence this does not seem to be a significant concern with respect to our estimates of the aggregate revenue effects.<sup>33</sup>

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<sup>33</sup> For robustness we also check whether the results are very dependent on the specific year we analyze. We look at year 2012 since this is the latest year available to us in the micro data source. If we instead use year 2011, the combined approach with the preferred sample restrictions above gives us an estimate of 19.6 percent. Using year 2010 gives 18.4 percent. Hence, the estimate seems to be relative stable across years.

c) *Where is the revenue coming from?*

We now turn to investigate which countries would be the source of the revenue from the income inclusion rule shown in the Base Case in Table 2.2. In Table 2.3 we show the results for the countries most affected, both in absolute amounts (in \$ million) and as a percentage of the profit of foreign controlled corporations. There are two sets of results, one for countries for which we do not have sufficient ORBIS data, based on the aggregate approach. The second is based on the micro data from ORBIS. Note that the aggregate approach will only record revenue when the estimated average ETR for the whole country is below the minimum tax threshold; this is not true for countries in the lower half of Table 2.3.

Country	Aggregate Approach (macro data), Base Case		Orbis approach (micro data)	
	\$million	% of foreign controlled profits	\$million	% of foreign controlled profits
BVI	2 908	10.0		
Puerto Rico	2 878	6.7		
Ireland	2 651	3.9	370	0.5
Bermuda	1 949	10.0		
Cayman Islands	1 844	10.0		
Luxembourg	1 602	6.1	1 380	5.3
Panama	893	5.0		
Bahrain	893	10.0		
Malta	644	5.1		
Lebanon	542	5.0		
Macau	540	5.0		
Curacao	475	5.0		
Mauritius	368	5.0		
Isle of Man	329	10.0		
Singapore	301	0.4	4 018	5.4
Jersey	258	5.0		
Bahamas	197	10.0		
Guernsey	179	10.0		
Barbados	154	5.0		
Turkey	152	4.2	29	0.8
Austria	0	0	489	4.3
Belgium	0	0	653	2.3
China	0	0	735	0.4
Czech Republic	0	0	145	0.8
Finland	0	0	160	3.8
France	0	0	741	2.3
Germany	0	0	1 646	3.8
Hungary	0	0	484	5.0
Italy	0	0	254	1.9
Netherlands	0	0	2 020	3.1
Poland	0	0	177	0.9
Russia	0	0	246	0.7
Spain	0	0	468	2.2
Sweden	0	0	291	1.2
United Kingdom	0	0	1 463	2.0

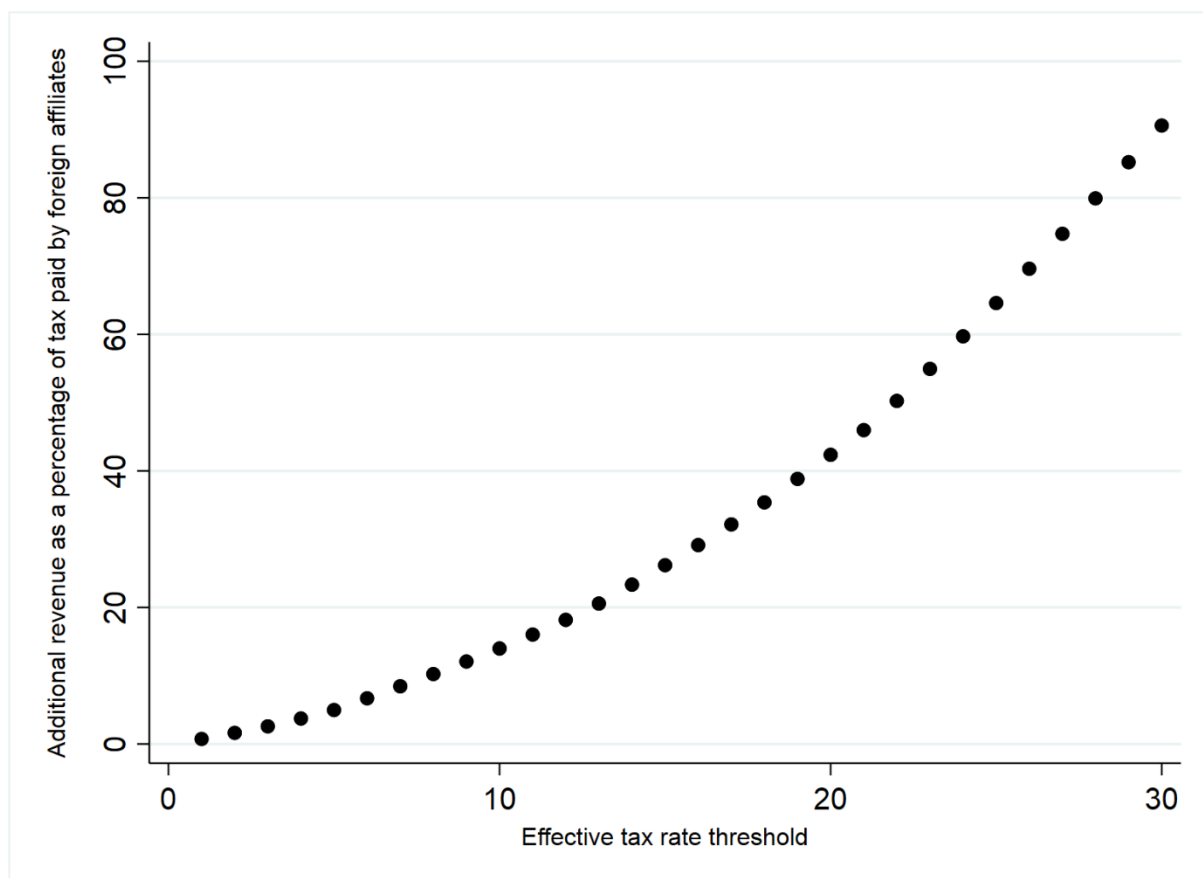
As noted above, we have a much smaller sample of countries when focusing on the micro data source. In Table 2.3. we include only countries with an estimated source of revenue from the income inclusion rule of at least \$100 million under at least one of these methods.

*d) Varying the chosen minimum threshold*

In the calculations above we have assumed that the minimum ETR threshold is set at 10 percent. Figure 2.1 shows how these estimates would change as the level of the ETR threshold changes. It shows revenue from the income inclusion rule as a proportion of the tax paid by foreign controlled corporations. We use our base case approach from Table 2.2 and apply it to different thresholds.

Not surprisingly additional revenue would be higher with a higher ETR threshold. Also, perhaps not surprisingly, this effect is non-linear: as the threshold rises the rate of increase in revenue also rises. This reflects the fact that a higher threshold would have two effects. First, as the threshold rises, more tax would be generated from countries and multinational businesses that already pay tax under the income inclusion rule, simply because the effective tax rate is higher. Second, as the threshold rises then, in addition, more countries and multinationals would also be drawn into the income inclusion net. Figure 2.1 illustrates the combined impact of these two effects.

**Figure 2.1: Revenue from the income inclusion rule using a country-by-country approach**



*e) Allocating revenue based on ultimate ownership*

So far, we have examined how much additional corporation tax revenue would be collected by the income inclusion rule implemented on a country-by-country level. Now we turn to estimating how the additional revenue would be allocated amongst countries.

We must make two assumptions to do so. First, we use data on the ultimate ownership of foreign-controlled corporations. This implicitly assumes that it is the country of the ultimate parent that would impose the charge based on the income inclusion rule, and which would receive the revenue. As we discussed in Part 1, this has so far not been made clear in the proposal. Second, as noted above, we assume that neither the multinationals nor countries change their behaviour in response to the implementation of the rule.

Using ownership data, we are able to estimate the share of revenue generated in each host country that is allocated to each parent country. First, we use the calculation of revenue coming from the macro data – i.e. approach 1 above, and then we distribute this revenue based on IMF FDI data. The IMF FDI data gives us an ownership distribution within each country – for example, it provides an estimate of how much FDI in Ireland comes from other individual countries, such as Germany, or Spain. We use these data to allocate the revenue raised by the minimum tax proposal in each source country to the countries which would implement the income inclusion rule and hence receive the tax revenue.

Note that this exercise is more speculative than the analysis above. Partly this is for the assumptions given here. Partly, though, it is because of the discrepancy for US multinationals noted above in the size of the profit of the foreign affiliates.

Table 2.4 shows the 10 countries that receive the highest additional revenue from the income inclusion rule using this approach. We show results using the approach which combines aggregate and micro data. The first column shows the estimated absolute amount raised (in \$ million).<sup>34</sup> The second column ranks countries by revenue expressed as a proportion of total tax on business profit raised in the country. Note that in this case, we consider only 78 countries for which we have data on total tax revenue. The third column ranks countries by revenue expressed as a proportion of the profit earned by foreign affiliates of parents resident in each country. And the fourth column ranks countries by revenue expressed as a proportion of the current tax paid by foreign affiliates of parents resident in each country.

For the comparison by absolute amounts, not surprisingly the largest countries – that host more and larger multinational company parents – generate the greatest additional revenue from the income inclusion rule; both panels are dominated by China and the USA. More surprisingly, perhaps, is the extent to which parent company ownership in Panama and Hong King is reflected in these countries taking third and fourth places in the two tables. Their prominence is a graphic illustration of the importance of the mobility of the residence of

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<sup>34</sup> Whilst there are some differences in the case in which we use only aggregate data, there is a substantial overlap. For example, in absolute terms, 9 of the top 10 countries are the same in the two approaches, with only Singapore replacing Germany in moving to the aggregate approach.

parent companies; it is perhaps unlikely that the OECD intends these two countries to raise so much revenue from the income inclusion rule.

<b>Table 2.4</b>				
<b>Top 10 receiving countries, using combined approach with IMF FDI Stock ownership</b>				
Rank	Ranked by total revenue	\$million	Ranked by revenue as proportion of total taxes on profit	% of total tax revenue
1	China	4 803	Estonia	10.9
2	United States	3 177	Latvia	9.5
3	Hong Kong	1 579	Hungary	7.9
4	Panama	1 508	Slovakia	5.0
5	France	1 437	Czech Republic	4.3
6	Germany	1 151	Slovenia	3.4
7	United Kingdom	1 123	Poland	3.3
8	Mexico	1 063	Mexico	2.8
9	Netherlands	969	Chile	2.8
10	Saudi Arabia	807	France	2.8
Rank	Ranked by revenue as a proportion of the profit earned by foreign affiliates	% of profit of foreign affiliates	Ranked by revenue as a proportion of the tax paid by foreign affiliates	% of taxes paid by foreign affiliates
1	Belgium	12.0	Kuwait	3036.4
2	Kuwait	9.7	Venezuela	67.5
3	Saint Barthelemy	5.0	Armenia	61.6
4	Venezuela	4.9	Saudi Arabia	50.2
5	Saudi Arabia	4.5	Pakistan	47.3
6	Armenia	4.2	Mozambique	38.3
7	Mozambique	3.9	Malaysia	29.4
8	Malaysia	3.9	El Salvador	28.1
9	Pakistan	3.5	Croatia	25.8
10	Indonesia	3.4	Indonesia	25.6

Note. Columns B, C and D exclude tax havens.

We should again note the uncertainty regarding these estimates. In particular, the estimate for the US of just over \$3 billion is based on the approach that yields an estimate of only \$235 billion in aggregate profit. If the true level of aggregate profit were closer to the \$650 billion estimated from US tax return data, then there would be a correspondingly higher estimate of the revenue gain to the US, possibly close to \$9 billion.<sup>35</sup> In this case there would be a correspondingly lower estimate for other countries. This clearly reveals a wide range of uncertainty.

Expressing the estimates in Table 2.4 as a proportion of existing taxes on profit gives a rather different dimension. In the approach using ORBIS data, the top 7 places are taken by countries from Eastern Europe. Estonia, for example, would raise its tax revenue by more than 10

<sup>35</sup> This matches the JCT estimate of the revenue gain to the US from introducing the GILTI provision.

percent with the universal introduction of income inclusion rule. For other countries, the additional revenue as a proportion of existing revenue is small. In the UK, for example, the additional revenue would be between 1 and 2 percent of existing revenue. In China and the USA it is a smaller proportion. This does raise the important question of the aim of the GloBE proposal. Raising revenue by 2 percent might be thought to be a rather poor return on a major tax reform initiative. In the UK, for example, with a tax rate of 19%, a rise in the statutory corporation tax rate by one percentage point would raise total revenue by roughly 5% - far more than the GloBE proposal, and far more easily accomplished.

Expressing the revenue from implementing the income inclusion rule as a proportion of the aggregate profits or taxation of foreign affiliates affected shows a third perspective. High-ranking countries in this list are those for which foreign affiliates of parents located there have particularly low ETRs and are therefore most affected by the introduction of the income inclusion rule. This group is dominated by low- and middle-income countries. One possible interpretation is that these countries have parent companies which engage more aggressively in shifting profit to countries in which they pay little or no tax. This in turn may reflect the relative weakness of their tax administrations.

## **2. Income inclusion rule implemented on a blended approach by multinational**

We now turn to estimating the revenue consequences of implementing the income inclusion rule, multinational-by-multinational, rather than country-by-country. Any individual multinational is likely to operate in many countries and therefore record profit in high-tax as well as low-tax countries. A blended approach would aggregate profit and taxes paid on all foreign activities of the multinational. Having an ETR in one country below the GloBE threshold would not trigger application of the income inclusion rule if the multinational was paying sufficient tax in another country so that its overall ETR was above the threshold. This suggests that this blended approach would raise less additional revenue for a given threshold than the country-by-country approach.

In this case, we use data from the consolidated financial statements of publicly listed US and non-US MNEs provided, respectively, in the COMPUSTAT and WORLDScope databases. This limits the analysis to the extent that we have data only for listed firms; any non-listed multinationals – which may include those resident in countries with small equity markets - are not included in our dataset.

In principle, these data give information on the foreign activities of the multinational, including foreign sales, foreign total assets, foreign operating income and foreign tax expenses.<sup>36</sup> For US multinationals we have access to consolidated financial statements for 9,285 firms in 2015. Around 20% of these have non-zero foreign pre-tax profits (2,103) or non-zero foreign income tax (2,296).

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<sup>36</sup> When possible, we remove any deferred income taxes from the income tax.



However, coverage is much weaker for non-US multinationals. Specifically, while we observe over 15,000 consolidated accounts for parents in non-US countries, only around 1% of these (around 200) of them include information on both foreign operating income and foreign tax expenses. Apart from being problematic for our study, this raises considerable doubts as to the ease with which this form of the income inclusion rule could be readily implemented outside the US. Since this small and highly selective set of companies is unlikely to provide a reasonable basis for our calculations, we impute foreign operating income using information on foreign sales.<sup>37</sup> This increases our sample size for non-US multinationals to 1,250. To proxy the foreign tax base, we allocate external interest expenses to foreign activities based on the share of foreign operating income and deduct it from foreign operating income.<sup>38</sup>

Overall, these disadvantages of the data restrict our analysis of non-US countries. Restricting the analysis to countries that have a minimum of 10 usable consolidated financial statements (in 2015), we are left with only 15 countries: Canada, Chile, China, France, Germany, Hong Kong, Ireland, Israel, Italy, Netherlands, Norway, Singapore, South Africa, Switzerland and UK.

For these countries we estimate the impact of the income inclusion rule using the same approach as in the previous section; we assume that there will be an income inclusion rule charge just sufficient to raise the ETR of the foreign activities of the multinational up to the ETR threshold. We report this additional tax revenue arising from the income inclusion rule as a percentage of the total foreign taxes paid by multinationals headquartered in a particular country. The advantage of using this as a measure of the impact of the income inclusion rule is that this does not require any scaling of the consolidated financial data; and it therefore does not depend on estimates of the aggregate foreign profit of domestic multinationals. To translate these into an estimate of the absolute revenue raised, it would be necessary to scale up the data we have used, using aggregate data. Of course, we cannot be sure that the impact on multinationals we do not observe would be similar.

Table 2.5 presents estimates separately for US and non-US multinationals, for 2015.

**Table 2.5. Revenue from the income inclusion rule from a blended approach, as % of foreign taxes paid, 2015**

	Threshold ETR		
	5%	10%	15%
Non-US	0.9	4.0	9.0
US	1.1	4.1	11.7
<b>Total</b>	<b>1.0</b>	<b>4.0</b>	<b>9.6</b>
Equivalent country-by-country ETR threshold		4-5%	7-8%

They are remarkably close. We estimate that, at an ETR threshold of 10%, US multinationals would pay tax of 4% of their existing tax liabilities; non-US multinationals would pay around

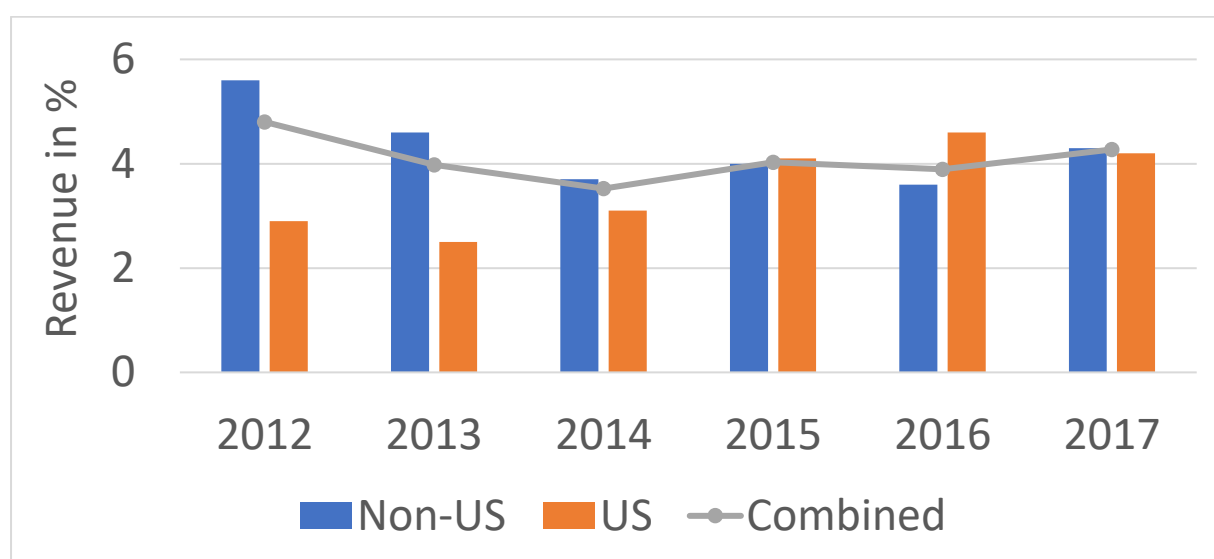
<sup>37</sup> More details are given in the Appendix.

<sup>38</sup> This assumes that the main difference between operating and taxable profits are external interest expenses.

4.1%. Given the uncertainty surrounding these estimates, these are effectively the same. There is a non-linear effect of changing the ETR threshold. For example, raising the threshold to 15% would more than double the revenue generated.

It is possible to compare this to the revenue that would be raised under a country-by-country approach. Very broadly, using the methodology set out above, an ETR threshold of around 4% to 5% would generate the same increase in revenue as a blended threshold of 10%. Of course, this does not make these two approaches – at thresholds that generate the same revenue - equivalent, for reasons set out in several places in this report.

**Figure 2.2. Revenue from the income inclusion rule under a blended approach, as % of foreign taxes paid, 2012-2107**



The similarity of the effects for US and non-US multinationals is not present for all years, however. Figure 3.2 presents the equivalent estimates for other years since 2012. If applied in the earlier years, the income inclusion rule would have raised more revenue from non-US multinationals. However, the position has been fairly similar in later years.

Table 2.6 explores the impact on revenue for each country for which we are able to undertake the analysis. In each case, it presents the number of multinationals used in the calculations, and our estimate of the additional revenue from the income inclusion rule that would be generated for ETR thresholds of 5%, 10% and 15%, again expressed as a percentage of foreign taxes paid. Again, caution should be taken in assessing these estimates due to the small sample size in some countries; and in some cases this may reflect the fact that large and important companies may not be included in the data.

There is considerable variation across countries, even leaving aside Israel which is a clear outlier. France, Italy and the UK would raise less than 1% of foreign taxes already collected. Ireland, South Africa and Norway would raise in excess of 10%.

**Table 2.6. Revenue from the income inclusion rule under a blended approach, as % of foreign taxes paid, 2015**

Countries	Number of Observations	Threshold		
		5%	10%	15%
Canada	34	1.00	7.42	15.06
Chile	18	1.37	3.74	6.1
China	80	0.88	2.10	3.48
France	21	0.04	0.12	0.5
Germany	81	0.03	1.41	6.3
Hong Kong	565	0.46	1.65	3.4
Ireland	24	2.39	10.60	19.5
Israel	17	22.15	106.40	196.1
Italy	17	0.00	0.00	0.03
Netherland	19	0.96	8.93	23.3
Norway	11	5.40	16.40	53.8
Singapore	62	0.20	0.91	3.1
South Africa	61	4.50	12.10	23.8
Switzerland	11	0.18	2.00	5.2
UK	227	0.15	0.65	2.1
US	2266	1.05	4.10	11.63

## **PART 3. The Impact of the GloBE on Incentives to Invest and to Shift Profit**

In the analysis in Part 2 we did not allow for the behaviour of business and governments to change as the results of the income inclusion rule being introduced. We now turn to a simulation study which estimates the impact of a universally adopted income inclusion rule on multinationals' incentives to undertake investment and the location of that investment, and also on the incentive to shift profits to low tax countries.

We examine the differences in these incentives under two of the possible income inclusion rule options, as in Part 2: a country-by-country basis, in which the parent's country levies an additional tax on the profit measured in any country where an effective tax rate (ETR) is below a threshold; and on an aggregate or worldwide blending approach, in which the additional tax is levied on the aggregate profit of the multinational group as a whole.

### **1. The simulation model**

We analyse a simplified framework in which the parent of a multinational makes three decisions:

- In which foreign country to locate a new investment;
- How much to invest, conditional on having chosen the location; and
- How much of the resulting profit to shift to a low rate tax "haven".

These decisions are related. Economic theory suggests that the first decision depends on the effective average tax rate.<sup>39</sup> Suppose the multinational is choosing between country H ("high" tax rate) and country L ("low" tax rate). It should choose the location which will yield the highest post-tax profit. This will depend on the economic conditions, and hence the pre-tax profit available, in each country, as well as the proportion of profit that is levied in tax in each country, typically measured by an effective average tax rate (EATR).

For our purposes, two important issues arise. First, it is unlikely that the income inclusion rule proposal would use the technical measure of the EATR commonly used in academic work.<sup>40</sup> Instead, it is more likely to use a measure of an effective tax rate (ETR) from financial accounts. The EATR considers the net present value of cash flows over the life of an investment; it is a measure of the net present value of taxes expressed as a proportion of the net present value of profit. By contrast, the latter is a one-period measure, expressing a tax liability in one period as a proportion of profit in the same period. The ETR therefore depends on the evolution of past investments, and their current profit. As such it is not well suited to determining the impact of taxes on investment decisions. However, the two concepts are broadly similar. In the Appendix we show that, under reasonable conditions, the EATR is a good approximation of the ETR. Indeed, if we calculate an ETR based on the present value of

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<sup>39</sup> See Devereux and Griffith (1998).

<sup>40</sup> See Devereux and Griffith (2003) for a measure that has been widely used in policy analysis.

taxes and profit – rather than simply a one-period measure - then a reasonable measure of the ETR would be equal to the EATR. We therefore use that as a proxy for the ETR.

Second, for our purposes here, we need to modify the commonly-used measure of the EATR to allow for profit shifting. That is, we want to consider the case in which the multinational shifts profit from either H or L to the tax haven. If the return to the investment is partially shifted to the tax haven, then the effective overall tax rate will be reduced. In turn, this may affect the initial location decision. We model profit shifting in a simple way, based on a common approach in the economic literature. Essentially, this implies that the multinational will shift profit to the tax haven up to the point at which the marginal benefit of shifting an additional \$1 – measured by the difference in tax rates between the two countries – is equal to the marginal cost. We do not observe costs. However, there have been many estimates of the sensitivity of the degree of profit shifting to differences in tax rates. Our base case analysis relies on a meta-analysis of existing research. Heckemeyer and Overesch (2017) present a semi-elasticity of 0.8 as a consensus estimate, implying that an increase in the host country's (i.e. H or L) corporate tax rate (relative to the tax haven) of 10 percentage points lowers reported pre-tax profits by 8%.

In our Base Case, we assume that the tax rate in H is 19%, that the tax rate in L is 12.5% and that the tax rate in the haven is zero. The precise estimates given below do, of course, depend on these assumed tax rates. However, the broader analysis does not; the conclusions would be the same for any broadly comparable tax rates.

Applying this consensus elasticity implies that 15.2% of profit would be shifted from H, and 10% of profit would be shifted from L. This reduces the EATR in both H and L, and also narrows the difference between the two. In turn, that makes it less likely that tax will play a dominant role in the location decision, so improving economic efficiency.<sup>41</sup>

We model the impact of tax on the scale of investment in the standard way, by examining how tax affects the required rate of return on the investment, or the cost of capital. Typically, taxes on profit raise the cost of capital, and hence they tend to reduce investment. In our model, this effect is also moderated by profit shifting, as the return to the investment is taxed at a lower overall rate, since part of it is shifted to the tax haven.

In principle, the model can be used in the context of any definition of the tax base – for example, including tax bases with more or less generous depreciation allowances. In our Base Case, we abstract from factors relating to the tax base by assuming that the rate of capital allowances permitted in the tax system is equal to the economic depreciation rate.<sup>42</sup> This has the advantage of simplifying the analysis and the interpretation of the results. In particular, in this special case, our measure of the ETR is not only equal to the EATR, but both are also equal to the statutory rate of tax. It should be emphasised that this is not a necessary feature of the simulation model. But we do use it as our Base Case, in order to focus more clearly on the overall impact of the introduction of the income inclusion rule.

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<sup>41</sup> This narrowing of the difference becomes more pronounced the higher the proportion of profit shifted.

<sup>42</sup> In our base case, we assume that this is 20%.

### *Analysing the impact of the income inclusion rule*

Within this framework we are able to analyse a number of scenarios for tax reform. For any such scenario we can in principle identify the effect of the reform on the impact of tax on the three decisions set out above. Furthermore, we can in principle see how the impact of any reform depends on the base line assumptions made – such as the tax rates in H, L and the haven, the extent of profit shifting, and the measurement of the tax base.

Specifically, we model the two key forms of the income inclusion rule. First, we consider the country-by-country approach. We analyse a range of values of the ETR threshold, applied potentially all of the countries. Since we assume that the haven has a zero tax rate, then the income inclusion rule would certainly apply to profits declared in that country. Suppose that the GloBE threshold were 10%. Then in the simple Base Case, that would effectively mean that profit shifted to the haven would be taxed at 10%. (For the purposes of this analysis, it does not matter which government receives the revenue.) That in turn implies that there will be less shifting from either H or L to the haven, since the gain from doing so is diminished. That will affect the EATR, the ETR and the cost of capital of investment in either H or L.

Note that the ETR declared in H and L may be affected by profit shifting, depending on how it is measured. As we noted in Part 1, any profit shifted from, say, H to the haven would probably also be deducted from the denominator of the ETR. In that case, the “*measured*” ETR in H would be unaffected by profit shifting; the tax liability should be equal to the statutory rate multiplied by the measured profit. The “*true*” ETR (i.e. expressed as a proportion of profit in H before shifting) would be lower, but that would not be easily observed by the tax authorities. Indeed, if that could be measured, then there would be no need for the GloBE proposal in the first place. In analysing the country-by-country approach we start by assuming that the ETR is correctly measured; however, that is not a vital element of the analysis.

Second, we consider the blended approach, where the income inclusion rule is applied to the multinational as a whole. Then the income inclusion rule would only be applied if the overall ETR were below the threshold. As long as the overall ETR is above the threshold, then the incentive to shift profit would be unchanged. However, there is no point in shifting profit to the haven if the overall ETR is below the threshold, thereby triggering additional tax.

### *Economic efficiency*

Before analysing the results, it is worth noting that the GloBE proposal could have two separate impacts on economic efficiency.

First, Englisch and Becker (2019) argue that the GloBE should improve global economic efficiency since it would reduce the spread of EATRs across different locations. The idea here is that distortions to location decisions induced by differences in EATRs create a social cost. Suppose that production is cheaper in H than L, but the business nevertheless chooses L for tax reasons. Then the higher cost in L represent a cost to the world as a whole. If the international tax system led to a situation in which the EATRs faced by a multinational were equal amongst all possible locations, then the location decision would not be affected by taxation. Other things being equal, reducing the dispersion in EATRs would move in this

direction, and therefore improve economic efficiency. Below we set out our results on the extent to which either of the income inclusion rule proposals would be likely to generate a significant reduction in the dispersion of EATRs.

Second, the scale of investment, and most likely the rate of economic growth, depends in principle on the cost of capital. The GloBE proposal would increase taxes and therefore would tend to raise the cost of capital and hence have a detrimental impact on investment. Again, we present results below on the extent to which this would happen under the alternative income inclusion rule mechanisms. Note that this is an inevitable trade-off with combating profit shifting. The OECD BEPS project targeted shifted profit and did not consider the impact on the location and scale of real economic activities. But to the extent that the BEPS proposals, or the GloBE proposal, are successful in reducing profit shifting, then they are also likely to reduce investment.

## **2. The impact of the income inclusion rule on profit shifting and location**

### *Income inclusion rule introduced on a country-by-country basis*

We begin our analysis by describing the impact on the proportion of profit shifted from country H, and the resulting EATR in country H of the country-by-country income inclusion rule. The results are shown in Figure 3.1.

Figure 3.1 plots on the horizontal axis a range of threshold values of the ETR. These effectively define the tax rate which would be levied in the tax haven, and also potentially in H. At the extreme left of the Figure is the position with a zero threshold, where the GloBE effectively does not operate. When the threshold ETR moves above 19%, the tax rate in H, then additional tax is also levied on any profit in H.

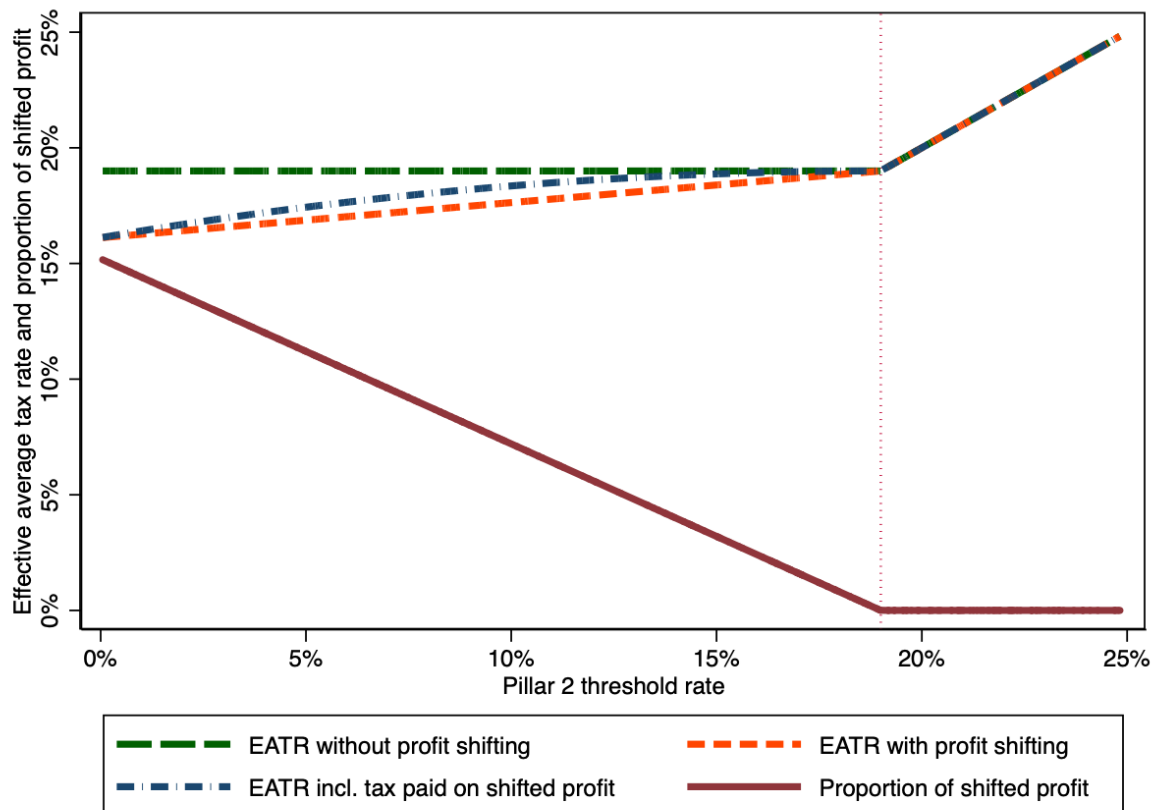
As a benchmark, the EATR (and ETR) in country H in the absence of any profit shifting is given by the dashed green line. Given our assumptions about the tax base, this is simply equal to the statutory rate in H, 19%. When the GloBE threshold ETR rises above 19%, then additional tax is levied and so this ETR also rises in line with the threshold ETR.

The unbroken line shows the proportion of profit shifted from H to the haven. As noted above, if no tax is levied in the haven then our base case assumption is that 15.2% of profit is shifted. However, as the effective tax rate in the haven rises with the GloBE threshold ETR, the benefits to the multinational of shifting profit are diminished. Consequently, the proportion shifted falls. Eventually, when the GloBE threshold ETR is at 19% there is no longer any gain to shifting profit, and the proportion falls to zero.

The decline in profit shifting as the GloBE threshold rises is reflected in two measures of the EATR. The dotted orange line shows the EATR taking into account only the tax paid in H. The blue dotted line shows the overall EATR, including tax paid in all countries (including that of the parent company, which is assumed to be implementing the proposal). The EATR in the absence of the GloBE is around 16%. Both measures increase slowly as the GloBE threshold

increases, until they both reach 19% at the point at which the threshold reaches 19%. For higher thresholds, the EATR is simply equal to the threshold.

**Figure 3.1.**  
**Changes in EATRs in and proportion of shifted profits from country H: Country-by-country minimum tax**



The position for country L mirrors that for country H. The pattern of profit shifting and EATRs is similar; the only difference is that the levels are different, reflecting that L has a lower tax rate of only 12.5%.

Figure 3.2 shows the impact of the income inclusion rule on the overall EATR in H and L, at different threshold ETRs. The unbroken line is for country H and reproduces the blue dotted line in Figure 3.1. The green dashed line is for country L.

As described above, the EATRs can be interpreted as measuring the tax incentive to choose each country as a location. Clearly, in the absence of the income inclusion rule, country H has a higher EATR, despite shifting part of the profit to the haven. (The EATR would be zero in both H and L if *all* profit were shifted to the haven). Introducing the income inclusion rule at higher threshold rates raises the EATR in both countries. There is a negligible effect on the difference between them until the GloBE threshold reaches 12.5%. At that point, the multinational would no longer shift profit from L to the haven. And for thresholds above 12.5%, the income inclusion rule would introduce additional tax in L. The EATR in L then



becomes equal to the threshold ETR, and so then begins to rise sharply. For values of the threshold at 19% and above, the EATRs in the two countries would be the same.

**Figure 3.2.**  
**Comparing changes in EATRs on investment in country H and country L: Country-by-country minimum tax**

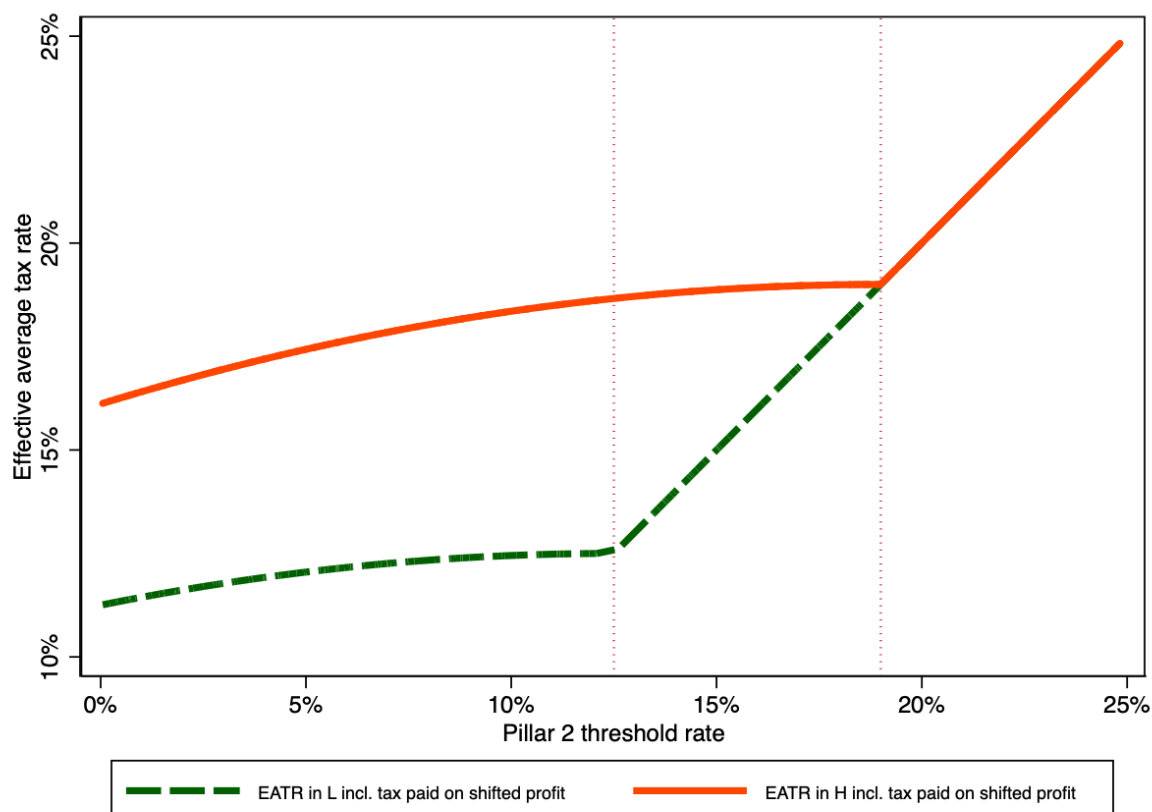
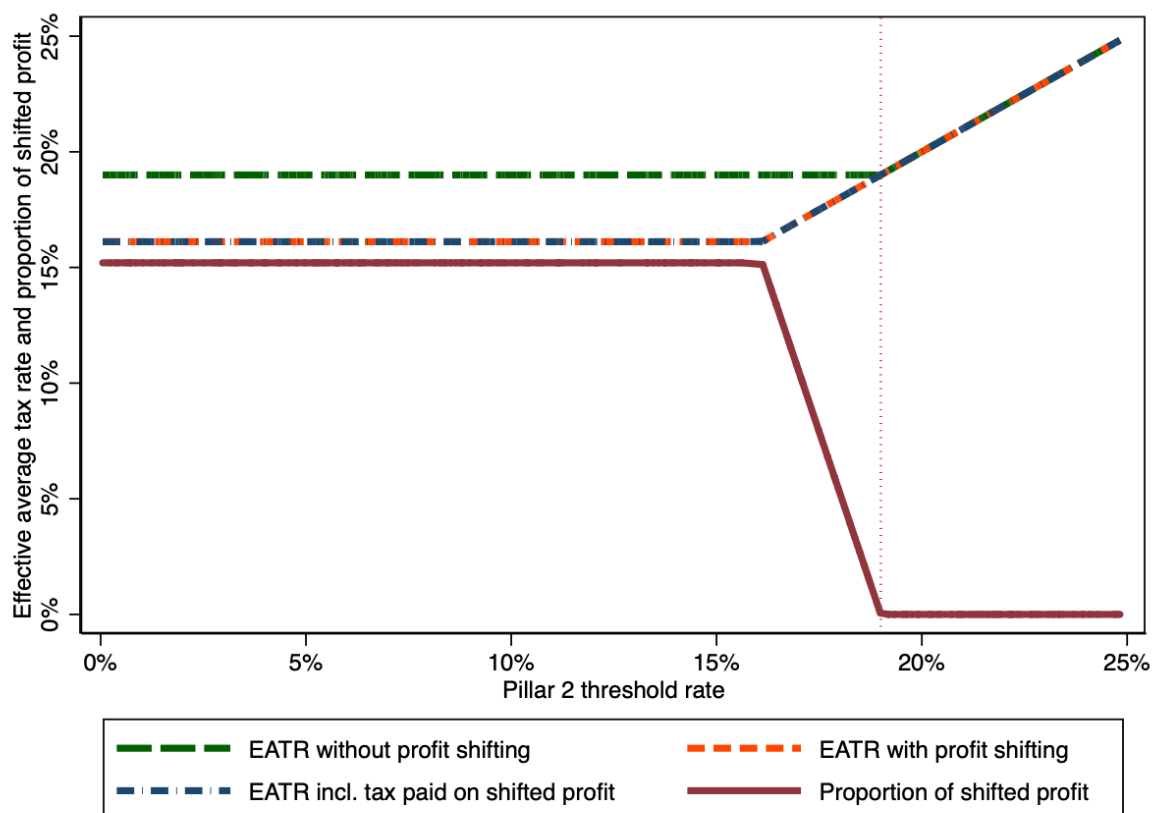


Figure 3.2 therefore casts light on the extent to which the international tax system would move in the direction of capital export neutrality with this form of the income inclusion rule proposal, as measured by the difference between the EATRs in the two countries, at any given GloBE threshold. Broadly, there is no discernible impact for levels of the threshold below the tax rate in L, 12.5%. For thresholds above that, however, the EATRs do move closer together. They become aligned (in the absence of any tax base differences) when the threshold is at, or above, the tax rate in the highest tax country.

*Income inclusion rule introduced on a blended basis*

We now turn to examining the case in which the income inclusion rule is introduced on a blended basis for the multinational as a whole. We follow the same approach as before. Figure 3.3 is the equivalent of Figure 3.1, but in this new setting. The dashed green line, showing the EATR in country H in the absence of profit shifting, is the same as in Figure 3.1.

**Figure 3.3.**  
**Changes in EATRs in and proportion of shifted profits from country H: Minimum tax on aggregate profit of MNE**

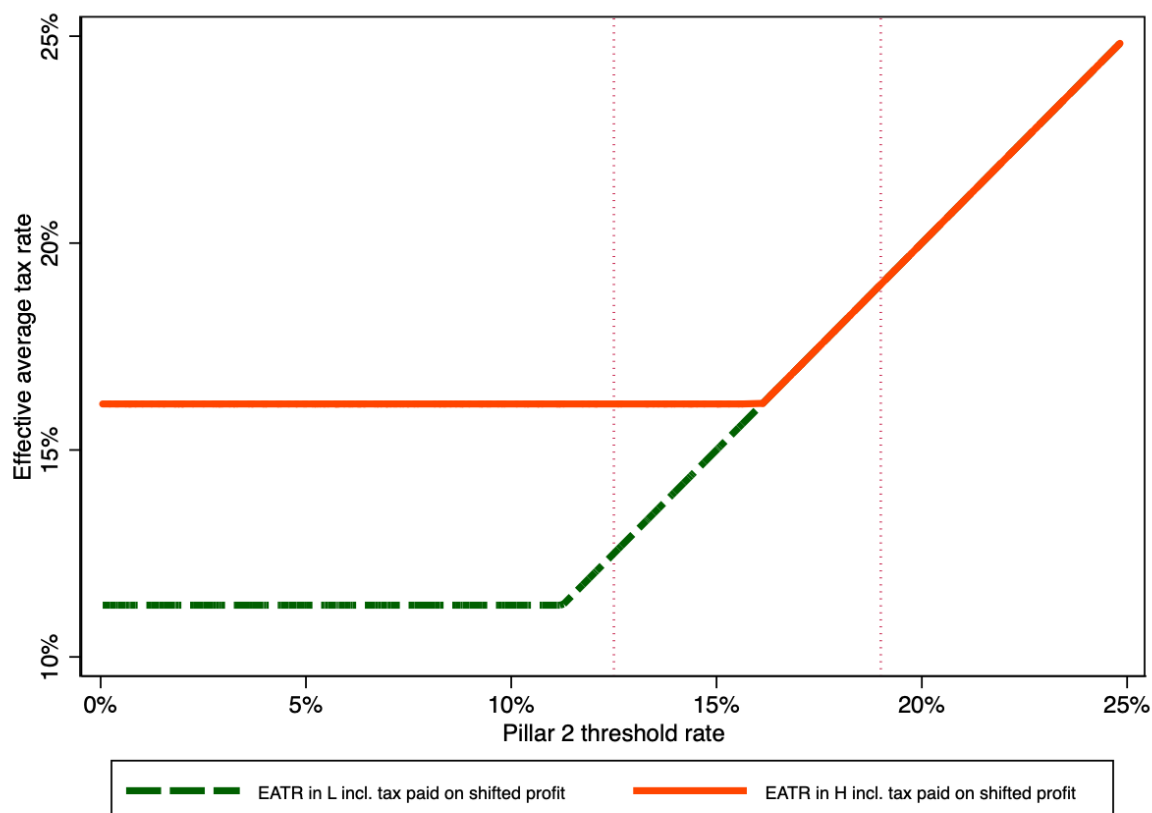


However, the incentives for profit shifting are now rather different. In the absence of the income inclusion rule, then the multinational would again shift 15.2% of its profit. But introducing a threshold below 16% on the whole of the multinational’s profit (assuming that it did not have any other profit) would have no effect. That is because the overall ETR faced by the multinational is already around 16%. There would be no GloBE liability unless this overall ETR threshold went above that rate. When that happens, as shown in the Figure, the incentive to shift profit to the haven falls dramatically. As in Figure 1, when the threshold reaches 19%, then there is no incentive to shift profit at all.

In this case, no tax is paid in the haven. As a result the other two measures of the EATR are the same. They are unchanged up to the threshold rate of around 16%, then they rise in line with the threshold.

Figure 3.4 shows the position of these EATRs for countries H and L together, as in Figure 3.2. Again, the unbroken line represents country H, and the dashed line represents country L. the pattern in the two countries is the same: there is no impact on the overall EATR up to the points at which it reaches the threshold. It then rises in line with the threshold.

**Figure 3.4**  
**Comparing changes in EATRs on investment in country H and country L: Minimum tax on aggregate profit of MNE**

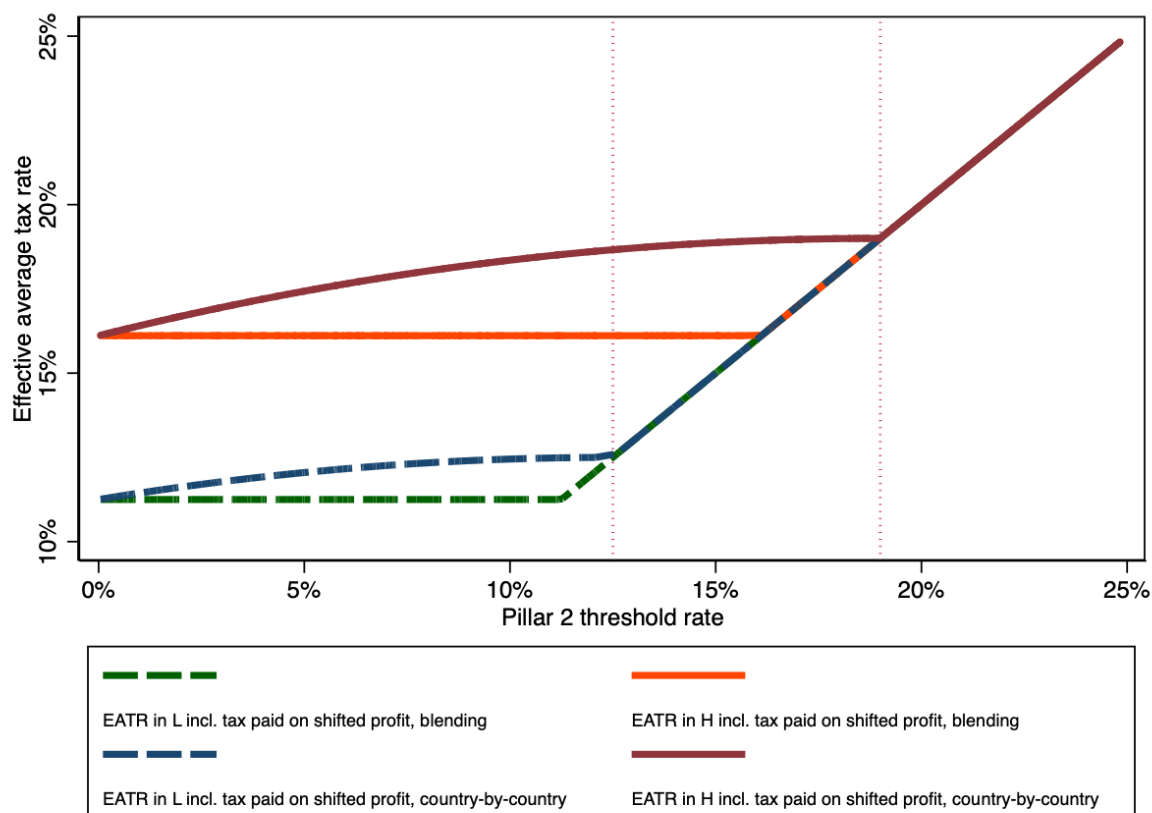


*Comparison between the country-by-country and blended approaches*

Figure 3.5 brings these two together, illustrating the differences between the two alternative income inclusion rule approaches. The pattern for the blended approach, also shown in Figure 3.4, is not dissimilar to that for the country-by-country approach, also shown in Figure 3.2. It is true that profit shifting is affected even at a very low threshold rate under the country-by-country approach, and so the EATRs rise immediately. For the blended approach, they do not change until the threshold rises to be equal to the EATR paid in the absence of the income inclusion rule. But the overall effect is broadly similar. Under the blended approach, there no reduction in the dispersion of EATRs – and so no movement towards economic efficiency - at low levels of the threshold. But at higher levels of the threshold, the income inclusion rule begins to bite in country L, raising its EATR in line with threshold, and eventually becoming equal to the EATR in country H.

**Figure 3.5.**

**Comparison between EATRs under a country-by-country and an aggregate minimum tax threshold**



### 3. The impact of the income inclusion rule on the scale of investment

We now turn to the impact of the income inclusion rule on the incentive to invest, given location and choices about profit shifting. This is measured by the cost of capital, the required rate of return on the investment, which we expect to rise as a result of taxation, thereby depressing investment.

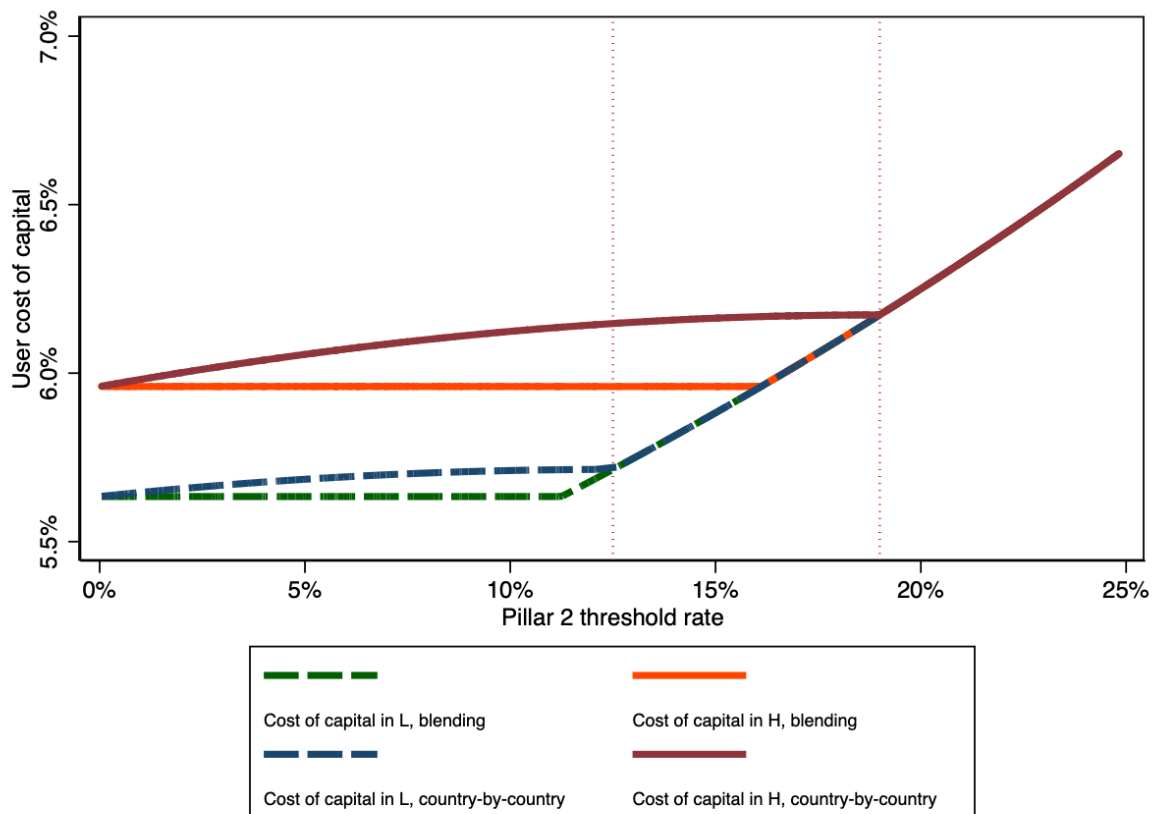
We have already studied the impact of the income inclusion rule on profit shifting and on the EATR and ETR under both scenarios, and in both countries. Since in this Base Case we are assuming that the tax base is equal to accounting profit, then the ETR is equal to the effective statutory tax rate (taking into account taxes in all countries). The cost of capital is then the required rate of return – here assumed to be 5% in real terms – grossed up by one minus the effective statutory tax rate.

This is shown in Figure 3.6. This is similar to Figure 3.5, in that it presents the cost of capital at different GloBE ETR threshold rates, for both forms of the income inclusion rule and for both countries. In fact the pattern of Figure 3.6 is remarkably similar to that in Figure 3.5. Under the country-by-country implementation of the income inclusion rule the cost of capital rises even at low thresholds, as profit shifting is immediately reduced, raising the effective

statutory tax rate. As the threshold reaches the tax rate in each country, the effective statutory rate rises in line with the threshold, creating a much sharper rise in the cost of capital.

A similar pattern arises in the blending approach. However, as with EATRs, because there is no immediate impact on profit shifting at low threshold rates, there is also no impact on the cost of capital. Only when the threshold rises above the overall ETR is any income inclusion rule charge applied, thereby pushing up the cost of capital.

**Figure 3.6.**  
**Changes in user cost of capital under different minimum tax thresholds and designs**



The trade-off between combating profit shifting and supporting investment is clearly seen in this Figure. The country-by-country approach has an impact on profit shifting even at low levels of the ETR threshold. This obviously raises aggregate tax revenues, but also raises the cost of capital and therefore tends to reduce investment. By contrast, the blended approach does not affect profit shifting at low threshold levels; it also does not affect the cost of capital and investment.

#### **4. Conclusions of simulation**

In this Part, we have analysed the possible effects of two key versions of the income inclusion rule proposal – implemented on a country-by-country basis and a blended basis. We have investigated the impact on incentives of where to locate real investment, how much investment to undertake, and how much profit to shift. We compare the versions of the income inclusion rule proposal for real investment in in two countries, with tax rates of 19% and 12.5%, where in either case profit can be shifted to a zero-rate tax haven.

There is a clear trade-off between the aims of reducing profit shifting and supporting investment. The country-by-country version of the income inclusion rule has an impact on profit shifting even at low levels of the ETR threshold. But as a result, it also raises the cost of capital at these threshold levels, and hence is likely to have a depressing impact on investment. The blended approach has a similar effect at high levels of the threshold but has little or no impact at low levels of the threshold. The level of the threshold at which it would have an impact depends on the tax rates in the countries concerned, and the aggressiveness of the multinational in shifting profit to a low tax country.

The other main element of interest is the extent to which the income inclusion rule would promote capital export neutrality by reducing the dispersion of EATRs on investment projects in different locations. The results suggest that at relatively low levels of the ETR threshold, there would be little or no convergence of EATRs – on either form of the income inclusion rule. There would be more convergence at higher thresholds, broadly when the threshold exceeds the tax rates in lower taxed jurisdictions in which multinationals would consider undertaking real investment projects.

We should note one important caveat of this study. In considering the blended approach in particular, we have modelled a business without any existing foreign operations. The income inclusion rule is then applied to a new investment without any consideration of existing profit and the rate at which it is taxed. To analyse the impact of existing activities and profit would require good data on the entire worldwide activities of the business, and the taxes that it pays in the absence of the GloBE proposal. Such data is generally not available, though country-by-country reports introduced by the BEPS project may provide information for such a study.

## PART 4. The GloBE and EU Law

The OECD's Programme of Work on Pillar 2 has recognised the importance of exploring whether the rules to be designed are compatible with existing international obligations<sup>43</sup> and specifically points to the need to explore the impact of the EU fundamental freedoms and "how that compatibility could depend on the rule's detailed design".<sup>44</sup> These concerns are shared by EU Member States. At the ECOFIN meeting held on 8 November 2019, the Presidency of the Council of the EU reported that since May 2019 intensive discussions had taken place at the EU level to evaluate the OECD's proposals regarding tax challenges arising from the digitalisation of the economy.<sup>45</sup> One of the central purposes of, and justifications for, the EU's involvement is ensuring that the GloBE proposal is consistent with EU law. In this context, "many Member States consider it important to conduct a timely examination of the EU law compatibility of the OECD proposal, as the negotiations evolve".<sup>46</sup> To address this issue, at the end of 2019, the ECOFIN Council committed to look more carefully at the initial findings on EU law compatibility of the proposed solutions, building on the work done by the Commission.<sup>47</sup>

The potential constraints placed by EU law on the design of the GloBE proposal come from three sets of rules. First, the fundamental freedoms enshrined in the EU treaties, most importantly the freedom of establishment (Article 49 TFEU), the freedom to provide services (Article 56 TFEU), and the free movement of capital – which also applies with respect to third countries (Article 63 TFEU). Second, fiscal state aid provisions (Article 107 TFEU). Third, existing secondary legislation adopted at the EU level, such as the Interest and Royalties Directive, which may need to be amended to accommodate the GloBE. This section focuses primarily on the impact of the free movement provisions and considers the two main elements of the GloBE proposal in turn.

### 1. An income inclusion rule

#### *Case C-196/04 Cadbury Schweppes and other relevant case law*

As set out above, an income inclusion rule would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate which is below a minimum threshold rate. The income inclusion rule therefore closely resembles CFC rules. This type of anti-tax avoidance measure has previously been subject to the scrutiny of the

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<sup>43</sup> OECD (2019c), Section 4.1(3).

<sup>44</sup> OECD (2019c), paragraph 78.

<sup>45</sup> Economic and Financial Affairs Council, 8 November 2019:

<https://www.consilium.europa.eu/en/meetings/ecofin/2019/11/08/>.

<sup>46</sup> Presidency of the Council of the European Union "State of Play: Digital Taxation": <https://data.consilium.europa.eu/doc/document/ST-13405-2019-INIT/en/pdf>, paragraph 10.

<sup>47</sup> Presidency of the Council of the European Union "State of Play: Digital Taxation": <https://data.consilium.europa.eu/doc/document/ST-13405-2019-INIT/en/pdf>, paragraph 14; OUTCOME OF THE COUNCIL MEETING 3725th Council meeting, Economic and Financial Affairs (8 November 2019): <https://www.consilium.europa.eu/media/41524/st13675-en19.pdf>.

Court of Justice of the European Union (hereafter “the Court”), including a landmark ruling from 2006 in Case C-196/04 *Cadbury Schweppes*.<sup>48</sup> In that case, the Court held that the EU’s freedom of establishment precludes the inclusion in the tax base of a company established in one Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in the second State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to “wholly artificial arrangements” intended to escape the national tax normally payable.

In that case, the Court therefore set a high bar for the lawful application of CFC rules by EU Member States. The Court specifically held that a “wholly artificial arrangement” arises when it can be demonstrated, based on objective factors which are ascertainable by third parties, that that company is a “fictitious establishment”, possibly with characteristics of a “letterbox” or “front” subsidiary. The establishment is regarded as “fictitious” if a company does not carry out any genuine economic activity in the territory of the host Member State, taking into account, in particular, the extent to which that company physically exists in terms of premises, staff and equipment.<sup>49</sup> The Court further concluded that such “fictitious establishments” can be subject to specific rules seeking to prevent tax evasion and avoidance and that the EU freedom of movement provisions do not preclude such a regime.<sup>50</sup> While in the more recent Case C-135/17 *X GmbH*, the Court indicated its willingness to soften the test of “wholly artificial arrangement” with respect to the cross-border movement of capital in the context of third countries,<sup>51</sup> it did not remove the substance-based test as such.

The following guiding principles can be distilled from Case C-196/04 *Cadbury Schweppes* and other relevant judgments delivered by the Court with respect to the application of anti-tax avoidance measures by EU/EEA Member States:

- A restriction of the free movement provisions can only be justified by certain overriding reasons of public interest, including the prevention of tax evasion and avoidance. This justification has been previously accepted by the Court in its own right, but it can also be taken together with some other grounds (such as safeguarding the balanced allocation of the power to impose taxes, or ensuring the effectiveness of fiscal supervision) which may provide some extra defence for Member States. For example, the effectiveness of fiscal supervision may justify more extensive measures applicable with respect to third countries if the level of administrative cooperation between tax authorities is less effective than that in place within the EU.
- A general irrebuttable presumption of tax evasion and avoidance has been repeatedly rejected as disproportionate, and such that cannot justify a measure which compromises

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<sup>48</sup> Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544.

<sup>49</sup> Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, paragraph 67.

<sup>50</sup> Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, paragraph 68.

<sup>51</sup> Judgment of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 84.



the free movement provisions.<sup>52</sup> For national legislation to be proportionate to the aim of preventing tax evasion or avoidance, it must, on each occasion on which the existence of artificial transactions cannot be ruled out, give the taxable person an opportunity, without subjecting him to undue administrative constraints, to provide evidence of any commercial justification that there may have been for the transaction at issue.<sup>53</sup>

The following sections apply step-by-step the analytical matrix employed by the Court in these cases to the proposed rules of the GloBE. By highlighting similarities and differences between the proposed GloBE rules and the CFC rules considered in *Cadbury Schweppes* this exercise provides guidance on whether the same or a possibly somewhat different outcome may be reached.

### *Restriction of the free movement*

First, it should be noted that since the income inclusion rule would apply to a foreign branch or a controlled entity, it would remain within the realm of the freedom of establishment (Article 49 TFEU). This would hold true as long as the implementing legislation intends to apply only to those shareholdings which enable the holder to exert a definite influence on a company's decisions and to determine its activities.<sup>54</sup> Whilst there is no universal threshold which would satisfy this test, the Court has earlier held that 15% of voting rights do not give rise to "definitive influence",<sup>55</sup> but it accepted that the holding of 25% is sufficient to satisfy the test.

According to settled case law, which also features in Case C-196/04 *Cadbury Schweppes*, if restrictive effects can also be found with respect to the free movement of capital, "such effects are an unavoidable consequence of any restriction on freedom of establishment and do not justify, in any event, an independent examination of that legislation in the light of Articles 49 EC and 56 EC".<sup>56</sup> This means that in relation to third countries, EU and EEA Member States would not be constrained by EU law and may adopt any solution agreed upon at the level of the Inclusive Framework on BEPS. However, if the shareholding requirement is not present in the legislation implementing the income inclusion rule, the situation may then fall under the free movement of capital, which does apply to third countries and thus the right of free movement would have to be respected.<sup>57</sup>

### *Comparability and difference in treatment which causes a tax disadvantage*

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<sup>52</sup> See, to that effect, judgments of 26 February 2019, X GmbH, Case C-135/17, ECLI:EU:C:2019:136, paragraphs 80 and 86; of 16 July 1998, ICI, C-264/96, EU:C:1998:370, paragraph 26; of 21 November 2002, X and Y, C-436/00, EU:C:2002:704, paragraph 62; and of 11 October 2007, ELISA, C-451/05, EU:C:2007:594, paragraph 91.

<sup>53</sup> See, to that effect, judgments of 26 February 2019, X GmbH, Case C-135/17, ECLI:EU:C:2019:136, paragraph 87; of 13 March 2007, Test Claimants in the Thin Cap Group Litigation, C-524/04, EU:C:2007:161, paragraph 82; of 5 July 2012, SIAT, C-318/10, EU:C:2012:415, paragraph 50; and of 3 October 2013, Itelcar, C-282/12, EU:C:2013:629, paragraph 37.

<sup>54</sup> Case C-251/98 Baars [2000] ECR I-2787, para 22.

<sup>55</sup> Case C-685/16, EV, Judgment of 20th September 2018.

<sup>56</sup> Judgment of 12 September 2006, Cadbury Schweppes and Cadbury Schweppes Overseas, C-196/04, EU:C:2006:544, paragraph 33 and the case law cited therein.

<sup>57</sup> The application of the free movement of capital is discussed in detail below with respect the undertaxed payment rule and will apply by analogy.

Second, it is necessary to consider the comparability of domestic and foreign subsidiaries and branches, and whether there is a difference in treatment can between the two.

It is settled case-law that the comparability of a cross-border situation with an internal situation within a Member State is examined having regard to the aim pursued by the national provisions at issue.<sup>58</sup> As soon as a Member State unilaterally taxes a resident company on the income obtained by a company established abroad, in which that resident company holds shares, the situation of that resident company becomes comparable to that of a resident company which holds shares in another resident company.<sup>59</sup> Both types of entities (i.e. subsidiaries and permanent establishments) are likely to be considered comparable in the light of the purpose of the implementing legislation and the fact that the home Member State is exercising its taxing right with respect to them.

With respect to the difference in treatment, the mere fact that the income inclusion rule attributes the profit of a separate legal person to the taxable person established in a Member State, which will not be the case with a taxable person holding a comparable shareholding in a company established in the Member State where it resides, would suffice to prove the difference in treatment of domestic and foreign subsidiaries.<sup>60</sup> Therefore, unless both domestic *and* foreign subsidiaries can be made subject to the income inclusion rule, the Court would have no difficulty in finding the difference in treatment.

The possibility of applying CFC rules to both domestic and foreign subsidiaries as a way of ensuring compliance with EU law has been previously advocated by the OECD in the final BEPS report on Action 3 (“Designing Effective Controlled Foreign Company Rules”): “if a CFC rule treats domestic subsidiaries the same as cross-border subsidiaries, it arguably should not be treated as discriminatory under the case law of the ECJ, and no justification is needed. Such an approach would attribute the allocable income of any controlled company, whether foreign or domestic, to its resident shareholders”.<sup>61</sup> This view is certainly merely “arguable”, as *de facto* domestic companies are unlikely to become subject to any additional tax under the income inclusion rule. Hence, the proposed extended application would be at risk of being seen as mere window-dressing, making it vulnerable before the Court.<sup>62</sup> This is not to say that if the GloBE implementation is left to national legislators, some Member States would not favour this approach; in which case the Court may be given an opportunity to decide on whether this solution is acceptable in the light of EU law. To enhance the robustness of the

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<sup>58</sup> See, to that effect, judgments of 26 February 2019, X GmbH, Case C-135/17, ECLI:EU:C:2019:136, paragraph 64; of 18 July 2007, Oy AA, C-231/05, EU:C:2007:439, paragraph 38; of 1 April 2014, Felixstowe Dock and Railway Company and Others, C-80/12, EU:C:2014:200, paragraph 25; and of 12 June 2018, Bevola and Jens W. Trock, C-650/16, EU:C:2018:424, paragraph 32.

<sup>59</sup> See, by analogy, judgments of 26 February 2019, X GmbH, Case C-135/17, ECLI:EU:C:2019:136, paragraph 67; of 12 September 2006, Cadbury Schweppes and Cadbury Schweppes Overseas, C-196/04, EU:C:2006:544, paragraph 45, and of 14 December 2006, Denavit Internationaal and Denavit France, C-170/05, EU:C:2006:783, paragraphs 35 and 36.

<sup>60</sup> See, by analogy, judgments of 26 February 2019, X GmbH, Case C-135/17, ECLI:EU:C:2019:136, paragraph 57; of 12 September 2006, Cadbury Schweppes and Cadbury Schweppes Overseas, C-196/04, EU:C:2006:544, paragraph 45.

<sup>61</sup> OECD (2015b), paragraph 22.

<sup>62</sup> See, to that effect, judgment of 5 April 2014, Hervis Sport, Case C-385/12, EU:C:2014:4.

“equal treatment” argument, Englisch and Becker (2019) argued that if the income inclusion rule is applied to domestic and foreign subsidiaries “regardless of the level of effective taxation of their profits, it would be truly non-discriminatory”.<sup>63</sup> While this step may make the proposal more robust in the light of EU law, from a design point of view it would certainly be suboptimal due to the even heavier administrative burden it would entail.

With respect to permanent establishments, the income inclusion rule would only apply where the profit of a permanent establishment is disregarded at the level of the head office (i.e. exempt foreign branches). The income inclusion could be achieved through a switch-over rule that would allow the residence state to use the credit method instead of the exemption method where the profits of a permanent establishment are subject to tax at an effective rate below the minimum rate. In this scenario, it would be more difficult to demonstrate any difference in treatment as the company would be subject to tax on all of its profits regardless of whether that profit has been generated by the head office or by its permanent establishment in another jurisdiction.<sup>64</sup> In Case C-298/05 *Columbus Container*, the income derived from the profits of a German undertaking through a Belgian limited partnership was exempt for taxpayers residing in Germany under the double tax convention (DTC). However, the national legislation provided that, notwithstanding the DTC, if such a partnership is subject to a “low” tax on profits, that income was no longer exempt, but instead subject to the German tax regime with the tax levied in Belgium being credited against the taxable amount in Germany.<sup>65</sup> The Court acknowledged that the German tax legislation does not make any distinction between taxation of income derived from the profits of partnerships established in Germany and another Member State but it “merely subjects, in Germany, the profits made by such partnerships to the same tax rate as profits made by partnerships established in Germany”.<sup>66</sup> Further, foreign partnerships do not suffer any tax disadvantage in comparison with partnerships established in Germany and therefore “no discrimination resulting from a difference in treatment between those two categories of partnerships” have been found.<sup>67</sup> As a result of the application of the GloBE, a permanent establishment would be subject to a minimum tax, or to the tax rates applicable to the head office. By analogy this difference in treatment would not cause a tax disadvantage in the cross-border situation and therefore would not trigger protection under the free movement provisions.

#### *An overriding reason in the public interest and proportionality*

Third, according to the Court’s settled case-law, once the restriction on the freedom of establishment is established in principle, the Court will examine whether such legislation can be justified by overriding reasons of public interest. It is further necessary that its application is appropriate to ensuring the attainment of the objective thus pursued and does not go beyond what is necessary to attain it.<sup>68</sup>

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<sup>63</sup> Englisch and Becker (2019).

<sup>64</sup> See, to that effect, Judgment of 6 December 2007, *Columbus Container*, Case C-298/05, ECLI:EU:C:2007:754.

<sup>65</sup> Judgment of 6 December 2007, *Columbus Container*, Case C-298/05, ECLI:EU:C:2007:754, paragraph 35.

<sup>66</sup> Judgment of 6 December 2007, *Columbus Container*, Case C-298/05, ECLI:EU:C:2007:754.

<sup>66</sup> Judgment of 6 December 2007, *Columbus Container*, Case C-298/05, ECLI:EU:C:2007:754, paragraph 39.

<sup>67</sup> Judgment of 6 December 2007, *Columbus Container*, Case C-298/05, ECLI:EU:C:2007:754.

<sup>67</sup> Judgment of 6 December 2007, *Columbus Container*, Case C-298/05, ECLI:EU:C:2007:754, paragraph 40.

<sup>68</sup> See, to that effect, judgments of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 70; of 11 October 2007, *ELISA*, C-451/05, EU:C:2007:594, paragraphs 79 and 82; of 23 January 2014, *DMC*,

In Case C-196/04 *Cadbury Schweppes*, it was submitted by the UK and other governments that the legislation on CFCs was intended “to counter a specific type of tax avoidance involving the artificial transfer by a resident company of profits from the Member State in which they were made to a low-tax State by means of the establishment of a subsidiary in that State and the effecting of transactions intended primarily to make such a transfer to that subsidiary”.<sup>69</sup> In response, the Court reiterated that any advantage resulting from the low taxation to which a subsidiary established in another Member State is subject cannot by itself authorise the Member State of the parent company to offset that advantage by less favourable tax treatment of the parent company.<sup>70</sup> The need to prevent the reduction of tax revenue does not justify a restriction on a fundamental freedom.<sup>71</sup> This led the Court to the conclusion, which was broadly described above, that the mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State could not set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty.<sup>72</sup> A national measure restricting freedom of establishment may be justified and proportionate only where it specifically relates to “wholly artificial arrangements” aimed at circumventing the application of the legislation of the Member State concerned.<sup>73</sup>

If the purpose of the income inclusion rule were described similarly to the justification provided to the CFC rules in Case C-196/04 *Cadbury Schweppes* or, more recently, in Case C-135/17 *X GmbH*, in that it intends to prevent the artificial transfer of profits, the Court would be unlikely to reach a different conclusion. The conditions which have so far been imposed by the Court on the application of anti-avoidance measures would equally apply to the income inclusion rule and would require the introduction of a substance-based carve-out to satisfy the requirements of EU law. Yet, as discussed in Part I above, this carve-out – in the OECD’s view – may “undermine the policy intent and effectiveness of the proposal”.<sup>74</sup>

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C-164/12, EU:C:2014:20, point 44; and of 21 June 2018, *Fidelity Funds and Others*, C-480/16, EU:C:2018:480, paragraph 64.

<sup>69</sup> Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, paragraph 48.

<sup>70</sup> Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, paragraph 49; see, to that effect, Case 270/83 *Commission v France* [1986] ECR 273, paragraph 21; see also, by analogy, Case C-294/97 *Eurowings Luftverkehr* [1999] ECR I-7447, paragraph 44, and Case C-422/01 *Skandia and Ramstedt* [2003] ECR I-6817, paragraph 52.

<sup>71</sup> Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, paragraph 49; see, to that effect, Case C-136/00 *Danner* [2002] ECR I-8147, paragraph 56, and *Skandia and Ramstedt*, paragraph 53.

<sup>72</sup> Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, paragraph 50; see, to that effect, *ICI*, paragraph 26; Case C-478/98 *Commission v Belgium* [2000] ECR I-7587, paragraph 45; *X and Y*, paragraph 62; and Case C-334/02 *Commission v France* [2004] ECR I-2229, paragraph 27.

<sup>73</sup> Judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, paragraph 51; see to that effect *ICI*, paragraph 26; Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779, paragraph 37; *De Lasteyrie du Saillant*, paragraph 50; and *Marks & Spencer*, paragraph 57.

<sup>74</sup><https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf>.

However, one important reservation needs to be made. As discussed in Part I above, the GloBE has two objectives. As its name suggests (the “global anti-base erosion” proposal), the income inclusion rule seeks “to address remaining BEPS risk of profit shifting to entities subject to no or very low taxation”.<sup>75</sup> However, if the GloBE is designed without a substance-based carve-out, it could be argued that this objective is merely consequential to the wider tax policy objective of ensuring that “the profits of internationally operating businesses are subject to a minimum level of tax”.<sup>76</sup> Indeed, without a substance-based carve-out the income inclusion rule resembles a worldwide tax system where all related entities would be subject to at least a minimum level of tax. Rather than seeking to justify this proposal as an anti-avoidance measure, one could in principle seek to justify the proposal on a new ground, such as establishing a level playing field for domestic and foreign investment by promoting capital export neutrality – although on the other hand the results shown in Section 3 suggest that the income inclusion rule would only have a relatively small impact on the dispersion of effective tax rates and hence on capital export neutrality. The adoption of the income inclusion rule through an EU Directive would certainly help to enhance the persuasiveness of this reasoning. In other words, the probability that the Court would accept this new justification for a GloBE proposal without a substance-based carve-out would increase if the 27 EU Member States give their unanimous consent to a directive implementing it.

To conclude, the most bullet-proof way of implementing the income inclusion rule in the EU with respect to controlled foreign companies would involve the harmonised application of a substantial activity carve-out for intra-EU situations, combined with a threshold holding requirement of above 25%. Whether such a carve-out would be considered as a universally desirable policy solution, or merely an acceptable departure from an otherwise “automatic” application of the income inclusion rule, by other members of the Inclusive Framework remains to be seen. The need to accommodate the constraints of EU law may require certain optionality in the global implementation of the GloBE, as was the case with some BEPS actions, such as CFC rules.

If a substance-based carve-out were adopted, this would lead to a similar approach to that applied by the EU Anti-Tax Avoidance Directive (ATAD) with respect to the CFC rules.<sup>77</sup> The ATAD offered EU Member States two options for implementing CFC rules and both were subject to a real economic activity test.<sup>78</sup> If however EU and EEA Member States, and other members of the Inclusive Framework, were politically determined to opt for the “automatic” application of the income inclusion rule without the substance-based carve-out, the GloBE might be applied by EU and EEA Member States with respect to both domestic and foreign

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<sup>75</sup> OECD (2015c), paragraph 3.

<sup>76</sup> OECD (2019e ), paragraph 7.

<sup>77</sup> Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (ATAD).

<sup>78</sup> See Article 7(2) of the ATAD. It is interesting to note that half of EU Member States opted for the first option, i.e. an “automatic” inclusion of certain predefined categories of undistributed (passive) income, which was subject to the substance carve-out (optional in third country situations). However, only a small minority of these Member States eventually chose to disapply the substance carve-out with respect to third countries. A majority of EU Member States opted for CFC rules with the same scope for both intra-EU situations and third countries, applying the substance requirement in both instances (based on the implementation survey reported by Deloitte at <https://www2.deloitte.com/global/en/pages/tax/articles/atad-survey.html>, as of February 2019). One can only speculate as to whether a similar scenario can be expected with respect to the GloBE.

subsidiaries. This step would seek to eliminate the difference in treatment between domestic and foreign subsidiaries, essential for proving the breach of the free movement provisions. Alternatively, the GloBE might also be defended as a minimum tax rule, a kind of a worldwide tax with the base profit taxed at the level to be determined and with a credit for tax already paid. Whilst arguable, neither of these two options is as certain as the substance-based carve-out.

## **2. The denial of deductibility for undertaxed payments or source-based taxation**

### *Restriction of the free movement*

As set out above, the undertaxed payments rule would operate by way of a denial of a deduction or an imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate. In effect, the rule would lead to a heavier tax on cross-border capital movements and thus would be seen as a restriction on free movement. Depending on the circumstances, this rule may infringe either the freedom of establishment, or the free movement of capital. The breach of the free movement of capital would have far-reaching consequences as this freedom prohibits any measures which are such as to discourage non-residents from investing in a Member State, or to discourage that Member State's residents from doing so in other States, *including* third countries.<sup>79</sup> However, if the notion of a "related party" for the purposes of applying of the undertaxed payments rule is subject to the holding threshold described above, the protection under the free movement of capital would be excluded. Any constraints emerging from the freedom of establishment would then apply exclusively to intra-EU scenarios.

### *Comparability and difference in treatment which causes a tax disadvantage*

As mentioned above, it is settled case-law that the comparability of a cross-border situation with an internal situation within a Member State is examined having regard to the aim pursued by the national provisions at issue.<sup>80</sup> As with the income inclusion rule, since the denial of deductibility for undertaxed payments would be limited to cross-border payments either *de jure* or *de facto*, the difference in treatment and the associated tax disadvantage can be established. This conclusion would equally apply to the freedom of establishment and the free movement of capital, as the Court has also repeatedly held that it would deprive Article 63(1) TFEU of all meaning if it were accepted that situations are not comparable solely because the investor deals with a third country.<sup>81</sup>

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<sup>79</sup> See, inter alia, judgement of 26 February 2019, X GmbH, Case C-135/17, ECLI:EU:C:2019:136, paragraph 55; judgments of 18 December 2007, A, C-101/05, EU:C:2007:804, paragraph 40; of 10 February 2011, Haribo Lakritzen Hans Riegel and Österreichische Salinen, C-436/08 and C-437/08, EU:C:2011:61, paragraph 50; and of 8 November 2012, Commission v Finland, C-342/10, EU:C:2012:688, paragraph 28.

<sup>80</sup> See, to that effect, judgments of 26 February 2019, X GmbH, Case C-135/17, ECLI:EU:C:2019:136, paragraph 64; of 18 July 2007, Oy AA, C-231/05, EU:C:2007:439, paragraph 38; of 1 April 2014, Felixstowe Dock and Railway Company and Others, C-80/12, EU:C:2014:200, paragraph 25; and of 12 June 2018, Bevola and Jens W. Trock, C-650/16, EU:C:2018:424, paragraph 32.

<sup>81</sup> See, by analogy, judgments of 26 February 2019, X GmbH, Case C-135/17, ECLI:EU:C:2019:136, paragraph 68; of 12 June 2018, Bevola and Jens W. Trock, C-650/16, EU:C:2018:424, paragraph 35.

### *An overriding reason in the public interest and proportionality*

As a starting point, it should be reiterated that the Court has held on several occasions that any tax advantage resulting from the low taxation to which a taxpayer is subject in the Member State in which it is established cannot, by itself, be used by another Member State as justification for according less favourable treatment in the latter State.<sup>82</sup> However, the undertaxed payments rule might be defended on the basis of (i) safeguarding the balanced allocation between Member States (and between Member States and third countries as the case may be) of the power to impose taxes; (ii) preventing tax evasion and avoidance; and (iii) particularly relevant in the third-country scenario, ensuring the effectiveness of fiscal supervision. Each of these justifications can be accepted in their own right, or taken together as a set of the overriding reasons in the public interest which are closely linked, as happened in the recent Case C-135/17 *X GmbH*.<sup>83</sup>

All of these justifications have been accepted by the Court on various occasions subject to some reservations already discussed above. Most notably, the Court has previously held that a national measure restricting the free movement provisions may be justified by the need to prevent tax evasion and avoidance where it specifically targets “wholly artificial arrangements” which do not reflect economic reality and the purpose of which is to avoid the tax normally payable on the profits generated by activities carried out in the territory of the Member State concerned.<sup>84</sup> As noted above, according to the Court’s settled case-law, a general irrebuttable presumption of tax evasion and avoidance is not acceptable and cannot justify a measure which compromises free movement.<sup>85</sup> On each occasion where the existence of artificial transactions cannot be ruled out, a Member State should give the taxable person an opportunity, without subjecting him or her to undue administrative constraints, to provide evidence of any commercial justification.<sup>86</sup>

Whilst the rationale of Case C-196/04 *Cadbury Schweppes* is fully applicable with respect to the undertaxed payments rule, two reservations need to be made. In Case C-135/17 *X GmbH*, which relates to CFC rules engaging the free movement of capital and involving a third-country scenario, the Court has indicated its willingness to soften the test of “wholly artificial

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<sup>82</sup> See, to that effect, *Eurowings Luftverkehr*, paragraph 44, and *Skandia and Ramstedt*, paragraph 52.

<sup>83</sup> See, by analogy, judgments of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 75; of 13 December 2005, *Marks & Spencer*, C-446/03, EU:C:2005:763, paragraph 51; of 21 January 2010, *SGL*, C-311/08, EU:C:2010:26, paragraph 69; and of 5 July 2012, *SIAT*, C-318/10, EU:C:2012:415, paragraph 48.

<sup>84</sup> See, to that effect, judgments of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 73; of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, paragraphs 51 and 55; of 13 March 2007, *Test Claimants in the Thin Cap Group Litigation*, C-524/04, EU:C:2007:161, paragraphs 72 and 74; and of 3 October 2013, *Itelcar*, C-282/12, EU:C:2013:629, paragraph 34.

<sup>85</sup> See, to that effect, judgments of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraphs 80 and 86; of 16 July 1998, *ICI*, C-264/96, EU:C:1998:370, paragraph 26; of 21 November 2002, *X and Y*, C-436/00, EU:C:2002:704, paragraph 62; and of 11 October 2007, *ELISA*, C-451/05, EU:C:2007:594, paragraph 91.

<sup>86</sup> See, to that effect, judgments of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 87; of 13 March 2007, *Test Claimants in the Thin Cap Group Litigation*, C-524/04, EU:C:2007:161, paragraph 82; of 5 July 2012, *SIAT*, C-318/10, EU:C:2012:415, paragraph 50; and of 3 October 2013, *Itelcar*, C-282/12, EU:C:2013:629, paragraph 37.

arrangement”.<sup>87</sup> The Court accepted that in addition to the indicators already provided in Case C-196/04 *Cadbury Schweppes* (paragraphs 67 and 68) that the establishment of a company does not reflect economic reality,<sup>88</sup> “*in the context of the free movement of capital, any scheme which has as its primary objective or one of its primary objectives the artificial transfer of the profits made by way of activities carried out in the territory of a Member State to third countries with a low tax rate*” can be lawfully captured by CFC rules.<sup>89</sup>

Furthermore, in the third-country scenario, the Court has previously held that, “where the legislation of a Member State makes entitlement to a tax advantage dependent on the satisfaction of conditions, compliance with which can be verified only by obtaining information from the competent authorities of a third country, it is, in principle, legitimate for that Member State to refuse to grant that advantage if, for example, because that third country has no treaty obligation to provide information, it proves impossible to obtain that information from that third country”.<sup>90</sup>

To sum up, the EU-compliant implementation of the undertaxed payments rule would need to be introduced with a substance-based carve-out in that a taxpayer should be provided with an opportunity to demonstrate that the transaction is genuine, in which case it would not become subject to disadvantageous tax treatment. The threshold for proving this fact may be lower than that emerging from the concept of “wholly artificial arrangements” and the rule may be allowed to capture “any scheme which has as its primary objective or one of its primary objectives the artificial transfer”. This conclusion rests on the assumption that the Court will apply the reasoning adopted in the recent Case C-135/17 *X GmbH* to intra-EU scenario.

### 3. Other relevant considerations

The OECD’s Programme of Work on Pillar 2 explicitly calls for the exploration of possible carve-outs. The above analysis has demonstrated that a substance-based carve-out would be the most robust option for ensuring EU law compliance for the income inclusion and the undertaxed payments rules. The inclusion of the carve-out for regimes compliant with the standards of BEPS Action 5 on harmful tax practices is not required in legal terms, but may be desirable to ensure the continuity of existing tax policies, such as those carried out through the EU’s Code of Conduct Group on Business Taxation and the OECD’s Forum on Harmful Tax Competition. If no substance-based carve-out is included, it remains to be seen how the work on a global standard on substantial activities in no, or only nominal, tax jurisdictions would be impacted by the introduction of the minimum tax.

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<sup>87</sup> Judgment of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 84.

<sup>88</sup> Judgment of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 84.

<sup>89</sup> Judgment of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 84.

<sup>90</sup> See, to that effect, judgments of 26 February 2019, *X GmbH*, Case C-135/17, ECLI:EU:C:2019:136, paragraph 92; of 18 December 2007, *A*, C-101/05, EU:C:2007:804, paragraph 63; of 10 February 2011, *Haribo Lakritzen Hans Riegel and Österreichische Salinen*, C-436/08 and C-437/08, EU:C:2011:61, paragraph 67; and of 10 April 2014, *Emerging Markets Series of DFA Investment Trust Company*, C-190/12, EU:C:2014:249, paragraph 84.



Further, the OECD's Programme of Work on Pillar 2 also explicitly mentions possible carve-outs for specific sectors or industries, which may be problematic from the perspective of EU fiscal state aid law. However, since no detail is available at this stage, no further analysis is offered on this point.

Other relevant considerations include the interaction of the GloBE with existing secondary legislation at the EU level. For instance, the Interest and Royalties Directive as it currently stands would preclude a withholding tax. Whilst the directive can be amended to accommodate the GloBE, the earlier proposed changes to this directive have been pending for several years. Similarly, the interaction between the GloBE and the CFC rules envisaged by the ATAD should also be considered. Whilst the directive-related constraints are in the hands of EU Member States and – unlike those originating from EU primary law – can be addressed, unanimity would be required to do so. The likelihood of EU Member States reaching a consensus on the GloBE should not be taken for granted. The recent example of the swift success with the adoption of the ATAD remains exceptional in the EU decision-making scene.

#### **4. Conclusion on EU law constraints**

EU law imposes certain constraints on the policy design of the GloBE. The application of the substance-based carve-out for subsidiaries affected by the income inclusion rule and payments caught by the undertaxed payments rule would make the GloBE resistant to possible challenges under the free movement provisions. The carve-out may only be strictly necessary for intra-EU scenarios; however, in that case, the holding requirements with respect to “controlled” companies and “related” entities should be put in place to insulate transactions from the application of the free movement of capital.

While limited possibilities exist to implement the income inclusion rule without the substance-based carve-out, none of the identified solutions is fully risk-free in the light of EU fundamental freedoms. If attempted, these solutions will exclude certain policy options under consideration, for instance, blending of the entire foreign activities of a multinational, and may require a secondary legislation at the EU level to enhance their robustness to possible legal challenges.

The question of the applicable substance-based carve-outs thus becomes critical not only from a policy point of view (as discussed in Part 1, Section 4), but also from an EU law perspective.

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